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Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2016-2017

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith a report on the economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States) for the period 2016-2017.

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Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2016-2017

Summary

This report presents the economic performance in the countries of the Economic Commission for Europe region in 2016 and early 2017 and future prospects. Moderate economic expansion continued, and the pace of activity has become more synchronized across the region. Growth in the European Union was faster than in the United States of America, temporarily reversing the trend that has characterized the post-crisis period. After a deep contraction, aggregate output in the Commonwealth of Independent States increased moderately again in 2016, while higher oil prices have improved the outlook. Inflation accelerated in the United States and the euro area, but monetary policy divergence remains, given the different positions in the economic cycle. By contrast, inflation has been falling in the Commonwealth of Independent States, as the impact of past exchange rate depreciation faded away. Despite significant uncertainty and country disparities, economic prospects in the Economic Commission for Europe region have brightened.

I. Introduction

1. The Economic Commission for Europe (ECE) region includes 56 member States, with very different development levels and economic situations. It contains most of the world's advanced countries but also a number of lower-middle income economies. For analytical purposes, the present report will divide this large and diverse number of countries into different subregions and group them into two major categories: advanced economies and emerging economies. Advanced economies include North America, composed of Canada and the United States of America; the countries that are part of the eurozone; and other advanced European economies. European emerging economies include new European Union member States that have not yet joined the euro area; non-European Union countries in South-Eastern Europe, including Turkey; and countries belonging to the Commonwealth of Independent States and Georgia.

II. Overview

2. Economic prospects have improved in the countries of the ECE region. Aggregate output increased by 1.6 per cent in 2016, down from 1.9 per cent in 2015. This recorded slowdown partly reflected some special circumstances, but the overall dynamics confirm a recovery that is becoming more synchronized across the region. Developments in early 2017 also suggest that the expansion is gaining momentum. There are, however, significant country differences, sources of uncertainty and unaddressed challenges that temper a generally positive economic outlook.

3. In the United States, a mature recovery, supported by steady consumption growth, continued to create jobs at a rapid pace. The euro area showed signs of increased dynamism, although concerns related to the banking sector persisted in some countries. The heavy political calendar and the decision by the United Kingdom of Great Britain and Northern Ireland to leave the European Union did not have a significant impact on confidence. In the new European Union member countries, the economic slowdown observed is temporary and related to the pattern of disbursement of European Union funds. After a poor performance in 2015, growth started to return in the Commonwealth of Independent States, as oil prices bottomed out and the macroeconomic framework became less volatile.

4. Rising but still moderate price pressures, prompted by stronger demand and higher energy prices, have led to further interest rate increases in the United States. In the euro area, a very loose monetary policy continued, but deflation is no longer a concern. A recent spike in inflation reflects largely higher energy prices, and it will abate. In some advanced countries, the extended period of low financing costs has led to rapid growth of asset prices, in particular housing. In the Commonwealth of Independent States, monetary authorities cut interest rates, as the inflation pressures prompted by past devaluations abated.

5. Despite this moderately positive performance, some challenges remain. Comparatively low levels of investment have contributed to the observed sluggish productivity growth across the region. Faster productivity growth increases are required to meet the challenges of ageing populations. In the Commonwealth of Independent States, the necessary economic diversification would require stronger investment activity.

6. While labour market dynamics have generally improved, unemployment rates are still high in some European countries, in particular for the young. Persistent unemployment erodes skills and can become structural. Increased structural unemployment, together with low productivity growth due to sluggish investment,

reduces potential economic growth. Low levels of economic activity can therefore have permanent effects.

7. The 2030 Agenda for Sustainable Development enshrines a commitment to promote environmentally sustainable and socially inclusive economies. Estimates by the International Energy Agency suggest that carbon emissions in the region fell in 2016, in particular in the United States, despite sustained economic expansion. Some negative impacts of the 2008 global financial crisis on social indicators are starting to be slowly reversed. While improved economic performance can facilitate achieving the Sustainable Development Goals, more robust policy action would be required, given the still moderate growth prospects and the scale of the environmental and social challenges ahead.

III. North America

8. The economy of the United Stated presents an overall picture of steady expansion, continuous growth in consumer spending, and increasing but still moderate inflation. Recent economic prospects have improved and suggest an acceleration of economic activity underpinned by solid consumer demand, rapid employment creation and a more favourable external environment.

9. In 2016, economic performance was dampened by the decline in the oil sector due to low oil prices and the negative impact of dollar appreciation on exports. Growth slowed to 1.6 per cent, down from 2.6 per cent in 2015. This was the lowest rate of expansion in five years.

10. Household consumption remains the main and most stable source of expansion. Consumer spending growth has been driven by rising real disposable income, as wages increased and oil prices remained low during most of the year. Financial conditions — low interest rates and improved access to credit — have also supported dynamic consumption. Household debt and debt service relative to income continued to fall, amid historically low interest rates.

11. The overall contribution of fixed investment to GDP growth declined sharply for the year as a whole, but quarterly figures reveal an improving trend, suggesting a growing momentum. Net investment has not increased in line with the number of hours worked in the post-crisis period. The amount of capital per worker has declined, which has contributed to the slow growth of productivity.

12. Relatively weak global demand and a strong dollar have dampened the growth of exports. While services have expanded rapidly, manufacturing, where exports play a more important role, has been trailing behind. The real trade-weighted dollar index rose by 3.9 per cent in 2016, following a 10.6 per cent appreciation in 2015. The real exchange rate is lower than in the period immediately after the financial crisis and softened somewhat in early 2017, but it remains high by historical comparison. Overall, the negative contribution of net external demand to GDP growth declined in 2016 but rose sharply in the last quarter of the year. The overall reliance of the United States economy on external savings remained unchanged, with the current account deficit reaching 2.6 per cent of GDP.

13. Labour market dynamics have been increasingly positive as the recovery matures. The unemployment rate returned to its pre-recession average by mid-2015 and has continued to decline, falling to 4.7 per cent by the end of 2016, down from 4.5 per cent one year earlier. The rapid pace of job creation continued in early 2017. However, there are other indicators, such as long-term unemployment and the share of labour force working part-time for economic reasons, that are still above their pre-crisis levels. This would suggest that the amount of slack in the economy

remains significant and that additional workers could be drawn into the labour force if economic expansion continues. The result of rapid job creation in the presence of only moderate output increases has been slow productivity growth.

14. Wages have been recovering more slowly than has employment in the post-crisis period, but the improvement of the labour market has finally translated into accelerating wage increases. Earnings for all employees rose by 2.8 per cent in February 2017, up from 2.4 per cent one year earlier. Real median household income stagnated for almost a decade in the years previous to the financial crisis and declined afterwards. In 2013, it staged a recovery, which was followed by rapid growth in 2016, reaching 5.2 per cent. However, after that increase, it remains 2.4 per cent below the peak observed in 1999.

15. Inflation remained low but started to pick up more rapidly in the second half of the year, ending 2016 at 2.1 per cent, up from 0.7 per cent one year earlier, largely reflecting the impact of higher energy prices. By contrast, core inflation (excluding food and energy prices), rose in a sustained way through 2015 but remained practically unchanged in 2016 and early 2017. It declined sharply in March 2017 to a level not seen since November 2015. Personal consumption expenditure inflation, the reference indicator used by the United States Federal Reserve, climbed through the year and reached 2.1 per cent in February 2017, just above its 2 per cent target. Inflation expectations have been increasing steadily but stabilized in early 2017. The 10-year break-even inflation rate, as derived from bond prices, had climbed from a low of 1.34 per cent at the end of June 2016 to just below 2 per cent by the end of March 2017.

16. Fiscal policy was broadly neutral in 2016, but there are expectations of some loosening, delivered through a combination of increased infrastructure spending and lower taxes, although full details of the future policy direction remain unknown. Following rapid declines in the period 2012-2014, the federal budget deficit rose by 0.7 percentage points to 3.2 per cent in fiscal year 2016.

17. The Federal Reserve remains the only central bank among advanced countries that has embarked on a tightening cycle. It started with a quarter-point increase in the target range for the federal funds rate in December 2015, to 0.75 per cent, which was followed by two additional, similar hikes in December 2016 and March 2017. As inflation is rising, further rate increases are expected, but the Federal Reserve has signalled that there was no rush for additional tightening, which has been borne out by the March inflation data. Further clarity regarding future fiscal plans will influence decisions on rate hikes.

18. Long-term interest rates have increased amid expectations of a recovering economy. The downward trend observed during the first half of 2016 came to a halt, with rapid increases observed in the last months of the year. In early 2017, after some softening, interest rates have recovered to reach the previous peak.

19. Although policy uncertainty remains significant, the most likely scenario for the immediate future appears to be a fiscal stimulus accompanied by a further tightening of monetary policy. This will result in higher long-term interest rates, which may have negative spillover effects for emerging markets depending on dollar financing. Monetary policy divergence between the United States and other advanced countries will support the value of the dollar.

20. Despite a sustained economic expansion, the United States economy faces some challenges. The slowdown in productivity remains an important concern, as productivity is the most important determinant of living standards over time. Over the past decade, average labour productivity growth was less than half the rate observed in the preceding decade, according to data from the Conference Board.

This is a problem that is shared with other advanced economies, where productivity growth has been even smaller. The decline in productivity growth is related to relative low investment levels in the post-crisis period as well as the declining rate of increase of total factor productivity, that is, productivity gains unexplained by increases in labour or capital and that are associated with innovation, technological changes and improved management. Increasing productivity would require policy attention to the factors influencing both the generation and, critically, the dissemination of innovation. Research carried out at the Organization for Economic Cooperation and Development shows how the productivity gap between frontier firms, where productivity growth is faster, and other firms has increased in advanced economies. This suggests that the factors influencing the dissemination of innovation should be a particular policy concern.

21. The United States economy made some progress in reducing its environmental footprint in 2016, as carbon emissions dropped by about 3 per cent, according to estimations by the International Energy Agency, despite continued output growth. This sharp decline in the carbon intensity of the economy resulted from an increase in shale gas supplies and the replacement of coal by renewable energy. Carbon emissions fell to the lowest level since 1992, in contrast with the expansion of the economy by 80 per cent since that year.

22. In Canada, the economic situation improved following the sharp deceleration observed in 2015, as a consequence of falling oil prices. GDP rose by 1.4 per cent, up from 0.9 per cent. The drag on economic growth from the oil and gas sector declined throughout the year, while other areas of activity picked up. In particular, exports have performed well, supported by the strength of the United States economy and gains in competitiveness due to the depreciation of the exchange rate. Overall, net external demand explained about half of the observed economic expansion. Non-energy investment performed well but was insufficient to prevent the continued contraction of overall investment. The unemployment rate declined slightly (6.6 per cent in February 2017, compared with 7.2 per cent one year earlier), reflecting the diverging fortunes of the energy and non-energy sectors. The policy mix, both fiscal and monetary, was supportive of growth. In order to offset contractionary trends emerging from the energy sector, infrastructure and social housing initiatives were developed to boost demand. Loose monetary policy propped up house prices, which increased rapidly in some key areas.

IV. Advanced European countries

A. Euro area

23. Economic expansion has been supported by the lagging effects of the euro depreciation, relatively low oil prices and a policy mix that has become more conducive to growth. Despite a number of shocks with a negative impact on confidence, including the outcome of the United Kingdom's referendum on European Union membership and lingering geopolitical tensions, the recovery remained resilient and growth has become more broadly based.

24. Recent performance suggests an improved economic picture, with the pace of economic activity expected to accelerate in 2017. Business and consumer confidence indicators reached fresh highs in early 2017, and consensus forecasts were revised upwards, despite existing uncertainties. The flash purchasing manager index for February showed that output was growing at its fastest pace in 70 months.

25. Overall growth figures in 2016 were distorted by the extraordinary performance of the Irish economy in 2015, which had a significant impact on

aggregate expansion, despite its relatively small share in total output in the euro area. Following the inclusion of some activities of multinational firms, as they switched their tax domicile to Ireland, recorded GDP growth in Ireland was 26.3 per cent in 2015. The slight deceleration in growth in the euro area to 1.8 per cent in 2016, down from 2.0 per cent in 2015 reflects the impact of the rapid reported expansion in Ireland in the base year for comparison. Excluding Ireland, there was a slight acceleration from 1.7 per cent to 1.8 per cent, according to European Commission calculations.

26. The expansion has been driven by domestic demand, as consumption was boosted by growing incomes and employment. Private consumption lost some momentum in the second and third quarters but accelerated in the fourth quarter.

27. By contrast, investment, which remains below pre-crisis levels, remained sluggish, despite the improvement in financing conditions. Investment is almost 2 percentage points below the prevailing level in the early 2000s, before the acceleration of investment in the years preceding the 2008 crisis. That poor performance is explained by the collapse of residential investment, which has only recently started to recover. In 2016, growing incomes and low mortgage rates supported a more dynamic housing sector, with increases in construction output and house prices, but high levels of uncertainty and relatively weak demand dampened overall investment. Funding did not appear to be the main problem, given accommodative monetary policies. Higher levels of capacity utilization and low financing costs should eventually lead to increased investment, although elevated debt levels in some cases and, more importantly, persistent uncertainty are creating powerful headwinds.

28. Growth of employment has been rather strong, given the moderate rates of expansion. Job creation has been supported by limited wage increases and, in some countries, labour market reforms. Unemployment, which was on a declining trend throughout 2016, reached 9.5 per cent in February 2017, the lowest level since May 2009. Unemployment is still around 2 percentages higher than before the global financial crisis and is much higher in some countries. Although the dispersion of unemployment rates was reduced, there are significant differences regarding both absolute levels and dynamics across the area. In Italy, the unemployment rate continued to grow in 2016, reaching 12 per cent by the end of the year. In contrast, Germany's labour market further improved, with the seasonally adjusted unemployment rate falling below 4 per cent for the first time since the reunification of the country.

29. Overall, favourable developments in the labour market have not yet made up for the losses incurred during the crisis. While the recovery has been job-rich, the growth in the number of hours worked has trailed behind. There has been an increase in the share of part-time employment, including involuntary. In addition, there are some groups, including the young and low-skilled, that have particularly large unemployment rates. Nevertheless, better labour market dynamics are having a positive effect on reducing poverty, as the share of people at risk of poverty and social exclusion, which rose in the post-crisis years, started to decline in 2015.

30. Inflation started to pick up in the second half of 2016, as oil price recovered from very low levels. However, core inflation was roughly unchanged, given the persistence of slack in the economy and the absence of wage pressures, including in countries with low unemployment levels. Annual inflation hit 2.0 per cent in February 2017, for the first time in four years, just exceeding the European Central Bank target, which was close to, but below, 2 per cent. However, core inflation remained steady at 0.9 per cent, and has been 1 per cent since August 2013. Differences in inflation rates across countries have narrowed. On the other hand,

because of the absence of stronger inflationary pressures in countries with less labour market slack, the adjustment burden of internal re-balancing has fallen upon the less competitive countries in the euro area.

31. The depreciation of the euro and rising commodity prices will push inflation higher in 2017, as suggested by market measures of inflation expectations. This may be a temporary occurrence: as base effects from higher oil prices fade away, inflation will also decline. The March projections of the European Central Bank foresee that annual inflation will reach 1.7 per cent in 2017, falling to 1.6 per cent in 2018.

32. Fiscal policy is no longer restrictive and has become broadly neutral. Public finances continued to improve on the aggregate, buoyed by better economic performance and very low interest rates. The European Commission estimated that the general government deficit fell by 0.4 percentage points to 1.7 per cent of GDP in 2016. However, the performance of individual member States differed widely. In France and Spain, the budget gap remained above 3 per cent. Six countries, including two outside the euro area, are under ongoing excessive deficit procedures. In some countries, measures to reduce the tax burden on labour have contributed to the decline of the revenue to GDP ratio. In others, there has been some fiscal loosening linked to the arrival of refugees. A constructive fiscal policy remains important to support the recovery and reduce imbalances within the euro area.

33. In six member States, the public debt to GDP ratio exceeds or is close to 100 per cent. High levels of government debt and modest growth imply that interest rate changes can have a large impact on debt sustainability. In this context, purchases of government assets by the European Central Bank have widened fiscal space by limiting increases in sovereign debt yields.

34. Renewed tensions and concerns over the sustainability of Greek debt emerged again, as economic expansion remains too slow to improve debt ratios. After posting some modest growth earlier in the year, the Greek economy contracted again in the last quarter of 2016. Most of the debt is now in public hands, after the 2012 restructuring, and the country has not enjoyed access to capital markets since 2014. Greece has already achieved a primary fiscal surplus, so the disbursement of additional financial support is necessary to honour its obligations vis-à-vis those official creditors.

35. The euro area continues to show a large aggregate current account surplus, reaching an estimated 3.6 per cent of GDP in 2016, as savings exceed investments. The crisis was followed by sharp adjustment in countries with large deficits, as external financing dried out. However, a similar correction did not take place in countries with surpluses, which have tended to grow further, thus resulting in an increasing current account surplus for the region as a whole. In Germany, the current account surplus started to grow rapidly in 2003, with the ratio to GDP increasing from 1.4 per cent to 8.7 per cent in 2016. Large external surpluses imply the continued accumulation of external assets.

36. Lending to households and non-financial corporations has continued to increase, amid declining interest rates and reduction of financial fragmentation across the euro area. However, differences across countries in both interest rates and the dynamics of credit remain. The banking sector has increased its capacity to support the recovery. The recent steepening of the yield curve has also reduced pressures on bank profitability, mitigating ongoing concerns on the negative impacts of loose monetary policy. However, profitability is low and banking fragility persists in some countries, which are still grappling with the legacy of non-performing loans. In a number of countries, including Ireland, Greece, Italy and Portugal, non-performing loans are still at double-digit levels, although for the region as a whole they are on a declining trend.

37. Financing remains cheap, with historically low interest rates and the continuation of quantitative easing by the European Central Bank. In March 2016, the European Central Bank increased the pace of asset purchases from 60 billion euros to 80 billion euros, to provide further momentum to the European recovery. In addition, it initiated a corporate sector asset purchase programme in June 2016, which contributed to easing financing conditions for non-financial corporations. In December 2016, it announced that purchases under the asset purchase programme would be extended until at least December 2017, while starting the reduction of monthly purchases to 60 billion euros in April 2017.

38. The European Central Bank asset purchasing programme has supported the narrowing of interest spreads between core and periphery countries. However, recently spreads in relation to German bunds have widened for some European countries. Demand for bunds have benefited from different risk perceptions but also from changes in European Central Bank rules that now allow purchases of bonds with yields below the deposit rate. Altogether, around 4 trillion euros of euro area sovereign bonds trade at negative yields.

39. Monetary accommodation will continue to ensure that inflation converges towards its target rate of close to, but below, 2 per cent. Recent increases in inflation appear temporary and driven by low energy prices, as European Central Bank forecasts show that inflation will still fall below this target in 2019. While the latest actions of the European Central Bank signal the continuation of a very loose monetary policy, fears of deflation belong to the past, as cyclical indicators are gaining momentum. The recent strength of the European economy has raised questions regarding the timing for winding down quantitative expansion. There are also lingering concerns regarding the side effects of sustained monetary expansion, including, in particular, negative interest rates. While monetary stimulus has led to credit growth in some countries, record low interest rates have also negatively impacted the profitability of banks and created misgivings with respect to potential resource misallocation. In addition, the European Central Bank is running out of assets to buy according to existing rules that forbid purchasing more than one third of a country's debt or a specific bond.

40. There is therefore a growing awareness of the limits of monetary policy to support the recovery and generate appropriate levels of demand and investment. A more balanced policy mix, including actions to support demand in the short term and increase medium-term growth potential are required. However, as countries with the largest need for fiscal stimulus are also those with larger debt levels, initiatives to support rebalancing within the euro area and structural reforms to increase productivity appear to be the most relevant.

41. Overall, the recovery is becoming well entrenched, but economic prospects remain clouded by significant uncertainty and persistent weakness in some countries. Further, the impact of some positive factors, such as low oil prices, is fading. Low productivity growth remains a major challenge, in particular in the face of rapidly ageing societies. This subdued growth can be partly explained by sluggish investment, but the poor performance of total factor productivity, i.e., that associated with innovation and improved management practices, suggests the need for continued attention to structural reforms that lift growth potential. In some countries, job creation has been associated with precarious employment, which is not conducive to productivity increases. While recent performance suggests an improvement in social indicators, the negative implications of the crisis on inequality in some countries has yet to be fully addressed.

B. Other advanced countries

42. In the United Kingdom, the referendum vote in June 2016 to leave the European Union dramatically changed the economic environment and introduced significant policy uncertainty regarding future arrangements. However, the performance of the British economy after this shock was better than initially envisaged, supported by an accommodating policy reaction. GDP growth slowed from 2.2 per cent in 2015 to 1.8 per cent in 2016.

43. The relative strength of the British economy, which largely outperformed the euro area economy in the second half of 2016, reflects the rapid growth of real earnings and its translation into robust consumption. On an annual basis, private consumption expenditure growth was 3.0 per cent, the fastest rate since 2014. Mounting inflationary expectations, linked to the depreciation of the pound, led to forward purchases. By contrast, investment, which is more sensitive to anticipated future economic performance, was sluggish. Employment growth has softened since the referendum, and the acceleration of inflation will erode real incomes.

44. The weakness of the pound has not boosted exports, which may partly reflect the weight of services and intermediate manufactured goods in British exports, as they are less sensitive to exchange rate variations. Net external demand made a significant negative contribution to growth in 2016. The current account deficit remains at around 5 per cent of GDP, which implies significant external financing needs.

45. Inflation accelerated, ending 2016 at 1.6 per cent, up from 0.2 per cent one year earlier. This was driven by higher oil prices and the depreciation of the pound, which fell by around 17 per cent against the United States dollar in 2016. In the aftermath of the referendum, monetary authorities adopted a number of measures to ease the cost of adjustment to the new situation, including cutting the policy rate to a record low 0.25 per cent and the extension of its quantitative easing programme.

46. Despite the relative resilience of the British economy, there are lingering concerns regarding the impact on trade, investment and future economic performance of the decision to leave the European Union. A protracted period of negotiations remains ahead and the most likely scenario appears to be that the United Kingdom will leave the single market and the customs union. The British economy represents around 15 per cent of the European Union economy, close to the combined weight of all the other European Union countries that remain outside the euro area, and therefore the United Kingdom decision to leave will have a sizeable impact on European Union aggregates.

47. The Swedish economy decelerated in 2016, as robust domestic demand was offset by the negative contribution to growth of net exports. With a 3.3 per cent increase, the pace of expansion remained strong. Inflation has started to increase, despite the appreciation of the krona, but is still low. The Riksbank extended its quantitative expansion programme by another six months in December 2016, with the repo rate at -0.50 per cent since February 2017. A very expansionary monetary policy has supported asset prices. The rapid growth of house prices has led to further increases in household debt. Migration inflows, albeit past its peak, have contributed to fiscal loosening and provided further impetus to the economy.

48. In Denmark, economic performance weakened, with GDP growth being down to 1.3 per cent from 1.6 per cent in 2015. The pace of expansion of households consumption, driven by robust employment and income growth, remained unchanged. Financial conditions are very easy, and this has fed into rapidly rising house prices, particularly in the capital. This has been accompanied by strong housing investment, which rose by 11.0 per cent. Inflation has been recently picking

up, due to higher energy prices and wages but it remained flat in 2016. The country has one of the largest current account surpluses in the European Union, although it fell somewhat in 2016.

49. Outside the European Union, the Norwegian economy slowed down, reflecting the impact of low oil prices, with GDP posting a 1 per cent increase, against 1.6 per cent one year earlier. The country has been using its ample fiscal reserves to offset the contractionary influences stemming from the energy sector, through a combination of tax cuts and increased expenditures. This fiscal stimulus is projected to continue in 2017. As the outlook for returns has worsened, the Government is advancing a proposal to reduce the amount of revenues that can be taken out of the oil fund from the current 4 per cent to 3 per cent. Inflation rose, pushed by a depreciating currency, but has now returned to a declining path. House prices have continued its rapid increase, fuelled by sustained low interest rates, with the Central Bank cutting the policy rate further to 0.5 per cent in March 2016. While financing costs are low, household debt is relatively high.

50. Economic growth accelerated somewhat in Switzerland, following the slowdown in 2015. Despite a strong franc, exports have held well, albeit with differences across sectors, while domestic demand is firming moderately. Inflation turned positive in January 2017, for the first time since August 2014, posting a 0.3 per cent annual increase. However, appreciating pressures over the franc as a safe haven have continued, and the Swiss National Bank has regularly intervened to contain them, resulting in large increases in foreign currency reserves and a very accommodative monetary policy. The strength of the franc has also been supported by the persistently large current account surplus of around 9 per cent of GDP.

V. Emerging economies

A. New European Union member States

51. Economic growth in new States members of the European Union moderated in 2016, but remained strong, dropping to 3.0 per cent, down from 3.7 per cent in 2015, as robust consumption offset weaker investment activity. Sluggish investment was linked to the beginning of a new programming period for European Union co-financed investments and followed years of very strong activity. Starting in 2017, the pace of drawdown of European Union funds will increase as new projects are submitted, and, over the coming years, transfers may reach 2-4 per cent of GDP annually. Increased investment will again become a major driver of growth. The economies of the new member States are very open and their performance is strongly influenced by demand conditions among external partners, namely other European Union countries. The improved prospects of the European economy will have a positive impact on this group of countries.

52. Favourable labour dynamics have been driven by continued economic expansion, and the external cushion provided by migration possibilities within the European Union. At the same time, labour shortages have emerged in particular areas. Falling unemployment has boosted consumption, amid rapid real wage gains. Increases in labour costs and, more recently, oil prices, have resulted in the acceleration of inflation from very low levels. Financing conditions have eased, with improved access to funding by households and corporates in the context of the declining share of non-performing loans, which has nevertheless remained quite high in many countries.

53. While the economic outlook is positive, there are also some sources of uncertainty that cloud the horizon. Any potential problems in the European Union

would quickly spill over into this group of countries, given the existing strong economic linkages. Migration flows and remittances will be negatively impacted by the planned exit of the United Kingdom from the European Union, which would eventually also have implications for fiscal arrangements within the European Union. This is significant for the new European Union member States, as they benefit from significant transfers.

54. In Czechia, after a very strong performance in 2015, with GDP posting a 4.5 per cent increase, economic expansion decelerated to 2.3 per cent. Strong employment growth fuelled household consumption. Net external demand also made a strong contribution to economic activity, while declining infrastructure projects resulted in the contraction of gross fixed capital formation. The strength of the recovery and rising inflation allowed the Czech National Bank to end its commitment to defending the euro/koruna floor in early April 2017. This arrangement was introduced in November 2013 to prevent the appreciation of the currency from adding to existing disinflationary pressures. The country is enjoying a comfortable fiscal position, with revenues boosted by sustained growth and public investment moderating after rapid expansion in recent years.

55. Economic activity slowed down in Hungary to 2.0 per cent, compared to 3.1 per cent in 2015, driven by the fall in investment. Domestic demand, however, remained strong, as wage and employment growth picked up in an increasingly tight labour market. Hungary's economic performance has been underpinned by rapid export growth, and net external demand continued to make a positive contribution to the economic expansion. Tax cuts and increases in the minimum wage in late 2016 will support further growth, adding to the expected pick-up in investment as the drawdown of European Union funds increases. Inflation accelerated throughout the year, and although it remains comfortably below the 3 per cent target of the National Bank of Hungary, it is expected to pick up. The decline in investment has been accompanied by an increase in the current account surplus, which is estimated to have reached around 5 per cent of GDP in 2016. The emergence of Hungary as a net external lender contrasts with the situation in the pre-crisis period.

56. In Poland, GDP growth slowed to 2.8 per cent, compared with 3.7 per cent in 2016. Private consumption was the main driver of economic expansion, reflecting falling unemployment, rising wages and the impact of additional social spending. This buoyancy contrasts with the weakness of investment prompted mainly by the beginning of a new programming period for European Union funds. The long period of deflation has come to an end, prompted by higher consumer spending and rising energy prices. In November 2016, inflation turned positive for the first time since June 2014, and it is expected to increase further. Public finances have improved, partly reflecting the drop in public investment. The introduction of a universal child benefit and the reduction of the statutory retirement age will increase spending.

57. In Bulgaria, economic expansion continued at similar rates, with GDP increasing by 3.4 per cent in 2016, boosted by strong consumption and, in particular, good exports performance. By contrast, gross fixed capital formation declined. Geopolitical tensions elsewhere have boosted the important tourist sector, which has, in turn, contributed to the widening current account surplus. Prices have been declining since 2013 but started to increase on an annual basis in January 2017. Labour market dynamics were positive, with lower unemployment being accompanied by large increases in real wages. Public finances also improved, owing to good economic performance and lower public investment spending, but also to some tax changes.

58. The pace of economic expansion accelerated in Romania, reaching a post-crisis high of 4.8 per cent. As in other new European Union member countries,

public investment was dampened by the impact of the European Union financing cycle, but that was more than compensated for by strong private investment. Consumption was boosted by growing wages, including in the public sector, amid an improving labour market. Average annual inflation was negative for the second year in a row, but base effects and the strength of domestic demand turned it positive in early 2017. Despite the low-inflation environment, the National Bank of Romania kept its policy rate unchanged throughout 2016 and early 2017. Robust domestic demand, supported by an expansive fiscal policy, led to a widening external deficit. However, growing foreign direct investment is contributing to increased export capacity.

59. Croatia, the newest European Union member, emerged from a long period of contraction in 2015, posting a 1.6 per cent expansion that gathered momentum in 2016 with a 2.9 per cent increase. The recovery was driven by domestic demand but was broad-based. Although there was some deceleration in the growth of exports of goods, the tourism sector performed well and the current account posted a sizeable surplus. Fiscal consolidation translated into a reduction of the ratio of public debt to GDP for the first time in six years. The unemployment rate, reaching 13.5 per cent in the last quarter of 2016, was considerably higher than in other new European Union countries, but has fallen sharply. Outward migration has also played a role in reducing unemployment.

B. South-Eastern Europe

60. In the Western Balkans, economic activity accelerated further in 2016, driven by the strong pick-up in Serbia, the largest economy in the subregion. However, there was some loss of momentum in several countries, in particular the former Yugoslav Republic of Macedonia. These economies are very closely linked to the European Union, which remains a major influence on economic prospects. Despite the acceleration of growth, inflation remained at very low levels. In early 2017, higher oil prices boosted inflation, but the impact was limited. Domestic demand, in particular investment, drove the expansion. Public investment in infrastructure continued to play an important role in Albania and Bosnia and Herzegovina. After years of moderation, improved dynamics in labour markets have boosted consumption. However, despite recent progress, unemployment remains high, exceeding the levels previous to the 2008 crisis, with the exception of the former Yugoslav Republic of Macedonia and Montenegro. Levels of long-term and youth unemployment are particularly high. In some countries, in particular Albania and Serbia, credit expansion supported the strength of domestic demand. By contrast, net external demand made a negative contribution to growth in most countries, with the exception of Serbia and, notably, Montenegro, owing to tourism revenues.

61. The subregion has accumulated large stocks of public debt, and fiscal consolidation efforts continued, although with mixed results. While positive progress was observed in Albania, Bosnia and Herzegovina and Serbia, further worsening took place in other countries. Financing of infrastructure remains a significant source of outlays in the former Yugoslav Republic of Macedonia and Montenegro.

62. The current account deficit grew in almost all of the countries of the subregion, with the notable exception of Serbia. In Albania and Montenegro, imbalances reached double-digit figures. In Albania, an oil exporter, low prices continued to dampen external performance. Growing investment in the subregion translates into large income payments, while remittances have declined. Foreign direct investment remains the main source for covering these deficits, but, as economies in these countries are increasingly dependent on external financing, they are vulnerable to a deterioration of global financing conditions.

63. In Turkey, economic growth nosedived in 2016, dropping from 6.1 per cent in 2015 to 2.9 per cent. Performance deteriorated in the second half of the year, with a 1.3 per cent decline in the third quarter of 2016, reflecting the negative impact on confidence of the failed July coup d'état, but bounced back strongly in the fourth quarter. Falling tourism revenues, which continued to decline in early 2017, had a contractionary impact. The depreciation of the lira, which gathered speed in the last quarter of 2016, pushed up inflation from already high levels, exceeding 10 per cent in February 2017. Geopolitical concerns and dwindling reserves, which barely cover short-term external debt, placed additional pressure on the currency. The Central Bank of Turkey deployed multiple tools to curb inflation, including liquidity measures to prop up the currency, but it has refrained from more aggressive interest rate hikes in view of the weakness of the economy. As in other emerging markets, the country suffered from capital outflows in anticipation of rising interest rates in advanced economies.

C. Commonwealth of Independent States

64. Economic performance improved in the Commonwealth of Independent States in 2016. After contracting by 2.3 per cent in 2015, aggregate GDP remained practically flat, with a 0.3 per cent increase. This mainly reflected a slower pace of contraction in the Russian Federation, down by 0.2 per cent, after shrinking by 2.8 per cent in 2015, according to revised data, and the return to sluggish growth in Ukraine after a severe recession. Recent dynamics and an improved outlook for commodity prices suggest that the expansion will gather momentum but, amid continuing fragilities, will remain modest in 2017.

65. Domestic demand, both consumption and investment, was very weak amid stagnating or declining real wages, poor access to credit and high uncertainty. In the Russian Federation, household consumption, which had been the main driver of the pre-crisis expansion, continued to shrink, with a 3.8 per cent fall that was less than half the precipitous decline observed in 2015. After dropping by 9 per cent in 2015, real wages remained practically flat in 2016 and started to show more dynamism in early 2017. Retail sales were strong in early 2017, partly owing to the impact of a one-off payment to pensioners to compensate for higher inflation. In Ukraine, the increase of the minimum wage supported the acceleration of real wage growth, with a positive impact on consumption. However, although consumer demand is gathering strength in the subregion, it is likely to remain a major dampener on growth.

66. Investment fared badly in most countries, with very large decreases in Belarus, Republic of Moldova and, in particular, Azerbaijan, where construction shrank by one quarter. By contrast, it staged a recovery in Ukraine. Net external demand partly offset these adverse developments. The ongoing fiscal adjustment in energy-exporting countries added to contractionary forces. In the Russian Federation, import substitution supported the performance of some sectors, namely agriculture and the chemical industry. Declining remittances from the Russian Federation depressed incomes in the small energy-importing countries in the region, but an improving trend emerged already in late 2016 and continued in 2017.

67. Despite weak output trends, labour market dynamics were relatively resilient. Sharp adjustment of real wages and underemployment have prevented unemployment figures from climbing higher. In the Russian Federation, unemployment showed little change, despite the ongoing recession, while in Ukraine, the muted recovery failed to make a dent in unemployment figures. In Kazakhstan, the unemployment rate edged lower, from already low levels, while the economically active population continued to shrink. In the smaller countries of Central Asia, returning migrant workers put pressure on local labour markets.

68. Inflation declined throughout the region as the impact of past currency depreciations wore off, exchange rates recovered and demand remained weak. In the Russian Federation, the rouble bottomed out in February 2016, and the ongoing exchange rate appreciation since then has supported the decline of inflation. In Ukraine, inflation declined sharply as the base effects from increases in the previous year's utilities prices dropped from the index, but it started to pick up in the last quarter of 2016 as the economy recovered. In Belarus, despite a large increase in regulated tariffs in early 2016, inflation stabilized but remained high in relation to other trade partners, despite price controls. Prices remained subdued in a number of smaller countries, including Armenia, Kyrgyzstan and the Republic of Moldova.

69. Declining inflation created room for continued loosening of monetary policy. However, monetary policy remained relatively tight in the larger countries of the region. Given persistent concerns about exchange rate stability and inflation, the scope for countercyclical monetary policy was perceived as limited in 2016. However, there were country differences regarding the pace of loosening.

70. In the Russian Federation, falling inflation, which reached 4.6 per cent in February 2017, and rouble appreciation, eventually prompted the Central Bank of Russia to start the easing cycle, with a cut of 0.25 basis points in March 2017 that left the key interest rate, unchanged since September 2016, at 9.75 per cent. Following the past appreciation of the rouble, with the trade-weighted exchange rate up by 38 per cent in the year leading up to February 2017, meeting the Central Bank's medium-term target of 4 per cent inflation appears less challenging. In Kazakhstan, interest rates remained high in early 2016 to support the exchange rate amid inflation levels that remained elevated. The rates came down gradually and, as inflation fell within the National Bank's target band of 6-8 per cent in January 2017, the base rate was cut to 11 per cent in February 2017, 6 percentage points below the level observed one year earlier. In Ukraine, interest rates decreased rapidly in the first half of 2016, but have remain unchanged at 14 per cent since October of that year. By contrast, the Republic of Moldova cut rates rapidly as inflation declined sharply throughout the year. In Armenia, despite ongoing deflationary trends and continued cuts, rates were kept at high levels.

71. Fiscal consolidation was widespread throughout the subregion. Energy producers, including those that entered the downturn with significant buffers, have undertaken measures to put public finances on a sustainable path and slow down the depletion of reserves and assets of the sovereign wealth funds. In the Russian Federation, public wages remained frozen for the second year in a row and benefits were only partially indexed. Despite an improved oil price, the authorities have announced their intention to refrain from spending the additional hydrocarbon revenues and to continue reducing the deficit. In Kazakhstan, the adjustment, including the reduction of lending activities by the oil fund, was accompanied by fiscal reforms to boost non-oil income.

72. In Ukraine, tax reforms, including cuts in the payroll tax rate, had a negative impact on revenues that needed to be compensated for. In addition, the rapid fall of inflation dampened revenues. In Belarus, despite a positive general government balance, the public debt has increased sharply owing to the impact of depreciation and quasi-fiscal operations. Large public debt is also limiting fiscal options in Kyrgyzstan.

73. External balances deteriorated in most countries in the subregion, including the two largest economies. As a result, the aggregate current account surplus shrank markedly, largely reflecting the decline of the Russian Federation's surplus by almost 70 per cent. Terms of trade for the subregion continued to deteriorate, albeit at a much reduced pace. They are expected to improve somewhat in 2017, as commodity prices increase.

74. In the Russian Federation, the onset of the recovery increased the demand for imports, while exports remained subdued. Lower net private capital outflows compensated for a shrinking current account surplus. Despite the persistence of sanctions, corporates have enjoyed improved access to external financing while Russian assets have attracted increased foreign interest. In Kazakhstan, the narrowing of the gap in the non-energy current account balance was insufficient to prevent a continued deficit, which almost doubled in 2016.

75. A major external adjustment has taken place in recent years in Ukraine, which has been supported by the depreciation of the hryvnia. As the economy recovered in 2016, the deficit widened, amid faltering exports. However, private capital returned to the country, a reversal of the trend observed in 2014-2015, when official sector inflows financed large outflows of private capital. The improved financing position more than offset the widening of the current account deficit, thus leading to increased reserves. However, the blockade of rail and cargo links and disputes over the control of key productive assets in the east of Ukraine in early 2017 may have a negative impact on economic performance and export capacity. In Belarus, the external financing position benefited from a $2 billion loan from the Eurasian Fund for Stabilization and Development, of which $800 million were disbursed in 2016. The agreement with the Russian Federation on gas import prices and oil deliveries concluded in April 2017 will contribute further to easing financing constraints. In the smaller Central Asian countries, in particular in Kyrgyzstan, current account deficits remain very large. After plummeting in 2015, remittances continued to fall, albeit at a reduced pace, before staging a recovery in late 2016.

76. Five countries of the Commonwealth — Armenia, Belarus, Kazakhstan, Kyrgyzstan and the Russian Federation — are members of the Eurasian Economic Union, which envisages free movement of goods, services, labour and capital and policy coordination in this economic space. In a context of overall declining trade and subdued economic performance, commercial exchanges among this group of countries shrank, despite progress in the development of an institutional framework for integration. However, the 7 per cent decline in exports within the block was far below the 19 per cent contraction observed in relation to third countries.

77. A fragile banking sector is becoming a source of budgetary outlays in some economies. Past exchange-rate depreciation, coupled with poor economic performance, has damaged asset quality. Supervisors in some countries are continuing efforts to clean up the banking system, including by reducing the number of licences. In Kazakhstan, the Problem Loans Fund is receiving additional resources, which will be partly financed by the National Oil Fund, to facilitate the recognition of bad loans in the banking system. In Azerbaijan, large transfers from the State Oil Fund have been earmarked to attend to the needs of the sector.

78. The economic outlook in the subregion has improved, but growth is likely to remain modest amid continuing downside risks. Past gains in improving living standards and reducing poverty have been eroded and faster, inclusive growth is required to reverse this situation. The recovery of commodity prices is expected to be limited. Energy-exporting countries are facing the reality of protracted low energy prices and the need to search for new engines of growth. Geopolitical risks are still present, undermining confidence. Lower exchange rates have provided opportunities for economic diversification. Progress in this area will need to be supported by appropriate policies that provide sustainable foundations for increased competitiveness in non-resource sectors, including by creating the conditions for substantially raising investment and addressing multiple infrastructure needs.

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Overview of economic and social conditions in Africa, 2017

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith an overview of recent economic and social developments in Africa for 2017.

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Overview of recent economic and social developments in Africa

[Original: Arabic, English and French]

I. Introduction

1. In 2016, overall economic growth in Africa declined drastically, dropping to 1.7 per cent, lower than the developing country average of 3.8 per cent. This growth performance was influenced greatly by outcomes in the six largest African economies and masks the remarkable growth, by at least 3 per cent, achieved by 32 countries in 2016. The resulting positive growth was generally underpinned by private consumption and investment (in infrastructure in several countries), made possible by improvements in the business and investment environments in many countries.

2. Even though commodity prices started to recover from the beginning of 2016 after falling for the previous two years, they still remain below their 2014 levels. This notwithstanding, growth in all the economic groups (oil-exporting, oil-importing and mineral-rich economies) slowed, registering 0.8, 2.5 and 2.2 per cent respectively in 2016. This slowdown led to uneven growth performance among the subregions, with East Africa recording the highest growth.

3. At the social level, the poor in Africa live much further below the extreme poverty threshold than in other regions, with an average consumption at about 60 per cent of the international poverty line. Despite numerous gains, inequality remains a key development challenge in Africa. The average within-country inequality levels in Africa are high and hamper the poverty-reducing effect of economic growth. Although significant progress has been made on the continent in terms of gender, gains have been uneven across countries and subregions and gender inequality remains a key development challenge in Africa.

4. The continent's medium-term prospects remain positive, buoyed by strong domestic demand and investment (particularly in infrastructure), a robust service sector, recovery in commodity prices and the focus placed by oil-exporting countries on non-oil sectors. Downside risks remain, however. The slower recovery in the global economy, consequences of the decision by the United Kingdom of Great Britain and Northern Ireland to leave the European Union, or "Brexit", on the European Union and other major global economies, uncertainty in the policy orientation of the new United States administration, the continued economic slowdown in China, and also weather-related, political and security risks, continue to pose a challenge for African countries. The long-term growth outlook for Africa is still promising, however, as its underpinnings remain relatively strong.

II. Developments in the global economy and their implications for Africa

5. Global economic growth declined marginally, from 2.5 per cent in 2015 to 2.3 per cent in 2016 (figure 1), reflecting a slight decline in growth in gross fixed capital formation (investment) and households' final consumption. The subdued global growth prospects are underpinned by persistently weak fundamentals, primarily in emerging markets and developing economies, mostly due to soft commodity prices, diminished investment, contracting trade, weak demand and rising inflation. Medium-term prospects appear slightly more positive, however, as growth is forecast to increase to 2.7 per cent in 2017, owing to the predicted

stronger performance in emerging and advanced economies. This global decline had significant implications for African trade and investment performance.

6. In developed economies, growth dropped from 1.9 per cent in 2015 to 1.8 per cent in 2016 and is expected to oscillate around 1.9 per cent in 2017. This is explained by the weak and fragile growth in many mature economies. In the euro area, recovery continues, with growth reaching 1.9 per cent in 2016, although impeded by Brexit. For its part, the United States slipped from 2.4 per cent in 2015 to 2.2 per cent in 2016 as the energy sector and manufacturing declined against a backdrop of subdued oil prices, relatively high exchange rates and softening among trading partners, all of which impeded growth in the developed countries. Japan's economic growth remains stuck at 0.5 per cent in 2016 owing to weak private consumption and a drop in its Asian trading partners.

7. Economies in transition contracted by 1.2 per cent in 2016, following a slump of 2.8 per cent in 2015, as many commodity-exporting countries were rocked by low prices, political uncertainty and a delicate international environment. The Russian Federation experienced negative growth of 1.9 per cent in 2016, deepened by fiscal retrenchment, and weakening household consumption and investment, exacerbated by international sanctions. By contrast, the countries of South-Eastern Europe experienced positive growth of 1.9 per cent in 2016, thanks to low energy prices and improved economic conditions in the euro area. The decline in private investment in China placed relatively heavy downward pressure on that country's gross domestic product (GDP), which is expected to grow by around 6.6 per cent in 2016, slightly lower than the previous year.

8. The global employment situation remains weak. Unemployment decreased from 6 per cent in 2013 to 5.9 per cent in 2014 (ILO, 2016). The global unemployment rate remained constant at 5.8 per cent in 2016, mainly as a result of labour market improvements in the advanced economies, while several emerging economies, such as Brazil, the Russian Federation and South Africa, struggled (ILO, 2016). In 2017, the unemployment rate is forecast to fall marginally to 5.7 per cent, even though the absolute number of unemployed is likely to surpass the 200 million mark.

9. World inflationary pressures remained muted in 2016, estimated at 0.7 per cent in advanced economies and 4.5 per cent in emerging and developing economies, compared to 0.3 and 4.7 per cent in 2015, respectively. This situation also led to divergences in monetary policy stances, as many large economies maintained or reinforced accommodative measures, while several developing economies were compelled to tighten their monetary policies in a bid to stem rising inflation. In developed countries, the overall inflation rate rose from 0.1 per cent in 2015 to 0.7 per cent in 2016 and is expected to climb to 1.4 in 2017 because of a recovery in economic prices and strengthening of economic activity. Inflation in the United States increased moderately to 1.2 per cent in 2016, after a fractional rise of 0.1 per cent in 2015, as a strong dollar and falling energy and food prices kept inflation in check. In the euro area, low commodity prices and monetary easing policy will pull inflation in the opposite direction, only allowing it to edge up by a mere 0.3 per cent in 2016. Inflationary pressures in developing and emerging economies eased slightly, from 4.7 per cent in 2015 to 4.5 per cent in 2016. Nevertheless, many oil exporting countries faced high inflationary pressures as their currencies depreciated in response to the price shocks (UNDESA, 2016).

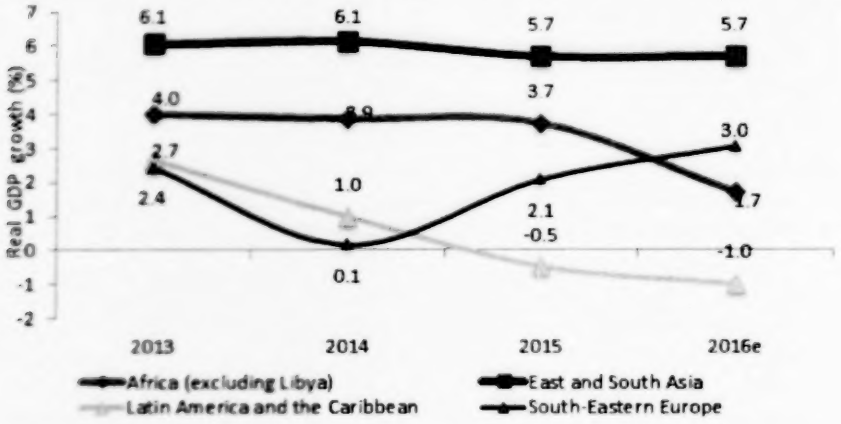
10. The medium-term outlook, albeit optimistic, remains subject to significant downside risks, with the prospects of most advanced economies looking dim. In the advanced economies, concerns intensify over the medium-term growth potential in the light of low aggregate demand, rising inequality and ageing populations. Persistently unfavourable terms of trade revealed the structural vulnerabilities of

several commodity-exporting, emerging and developing economies, which were further heightened by diverging monetary policies of the advanced economies. With reduced fiscal buffers, monetary authorities in many developing and emerging economies are struggling to square growth concerns with managing inflation, capital accounts and business confidence. Moreover, the lower medium-term growth potential of the continent's trading partners dampens its own economic growth prospects. All other things being equal, knock-on effects on African economies might include lower demand for its exports and decreased investment attractiveness, along with higher interest payments, as world financial markets become tighter and increasingly volatile (IMF, 2016a, 2016b).

III. African economic performance and prospects

11. Growth in Africa declined from 3.7 per cent in 2015 to 1.7 per cent in 2016 as a consequence of weak global economic conditions, persistent low oil prices and adverse weather conditions (figure 1). Among the developing economy regions, Africa's growth rate surpasses only that of the Latin American and Caribbean region, which contracted by 0.5 per cent in 2016.

Figure 1
Economic growth in Africa and emerging and developing economies, 2013-2016



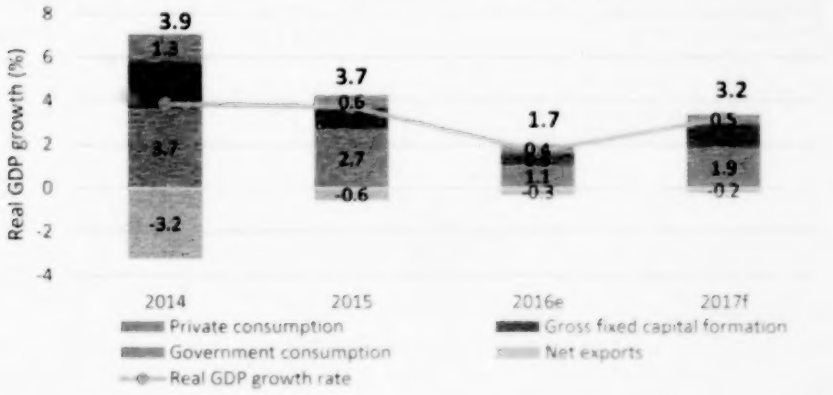
Source: ECA calculations based on UNDESA (2016) and EIU (2016) data.
Note: e = estimates.

A. Private consumption and investment as key drivers of growth

12. The positive economic growth performance in Africa was largely underpinned by the positive contributions of private and government consumption, and also by investment. Government consumption declined slightly, by 0.2 percentage points from 0.6 per cent in 2015 to 0.4 per cent in 2016 (figure 2). Similarly, growth of gross capital formation declined by about 0.5 percentage points, from 1 to 0.5 per cent (mostly because of lower oil prices, slowing demand across the world especially in China, persistent pressures on currencies and import restrictions). The net contribution by exports to GDP growth declined from 0.6 per cent in 2015 to -0.3 per cent in 2016, because of lower export revenues as a result of low commodity prices and subdued external demand. The contribution by private consumption also declined, from 2.7 per cent in 2015 to 1.0 per cent in 2016, because of lower agricultural

production resulting from adverse weather conditions, increase in inflation and a rise in interest rates, such as those experienced in Nigeria and South Africa.

Figure 2
GDP growth and associated components in Africa, 2014-2017

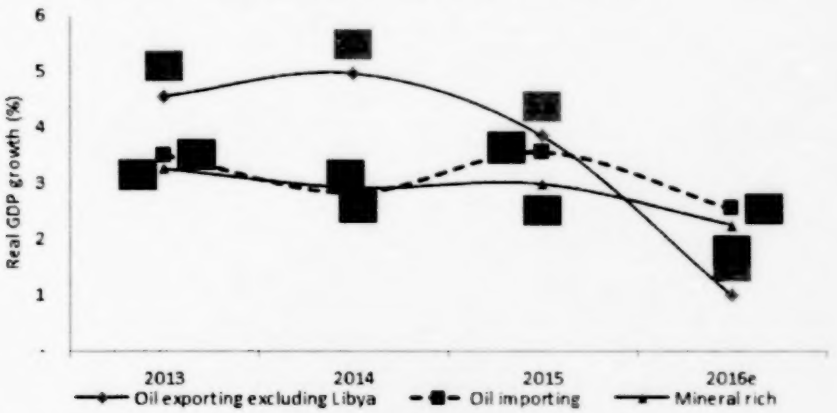


Source: ECA calculations based on UNDESA (2016) and EIU (2016) data.
Note: e = estimates, f = forecasts.

B. Varied growth among economic groups and among subregions, with East Africa in the lead

13. Commodity prices started to recover from the beginning of 2016 after falling for the last two years, but were still below their 2014 levels. This recovery notwithstanding growth in all the economic groups (oil-exporting, oil-importing and mineral-rich economies) decelerated, registering 0.8, 2.5 and 2.2 per cent respectively in 2016 (figure 3). Growth in oil-exporting economies fell from 3.8 per cent in 2015 to 1 per cent in 2016, partly because of the low oil prices observed since mid-2014, despite their recovery in 2016.

Figure 3
Growth performance in Africa by economic group, 2013-2016



Source: ECA calculations based on UNDESA (2016) data.
Note: e = estimates.

14. Among the African subregions, East Africa continued to record the highest growth, growing by 5.5 per cent in 2016, albeit down from the 6.2 per cent recorded in 2015 (see figure 4), mainly driven by good growth performance in Ethiopia, Kenya, Rwanda and the United Republic of Tanzania. Investment by Kenya in infrastructure and its buoyant household consumption have continued to drive growth in the subregion. The weakness of the tourism sector, however, due to security concerns and the high interest rate that has pushed up the cost of credit, could adversely affect growth in the medium term. In Rwanda, the growing agriculture and service sectors are driving growth, although lower commodity (coffee and tea) prices and poor infrastructure will remain a significant barrier. In the United Republic of Tanzania, the robust domestic demand together with the growing services and manufacturing sectors were the main drivers of growth. Growth in Ethiopia continues to be driven positively by public spending in infrastructure. Growth in East Africa is set to continue and lead the rest of the subregions in the forecast period 2017-2018, backed by robust growth in countries such as Kenya, Rwanda and the United Republic of Tanzania and benefiting from low oil prices and expanding public investment.

15. Growth in West Africa declined sharply, from 4.4 per cent in 2015 to 0.1 per cent in 2016 (figure 4), mainly as a consequence of the economic contraction in Nigeria — the continent's largest economy — caused by depressed oil prices, falling oil production, energy shortages and price hikes, scarcity of foreign exchange and depressed consumer demand. Similarly, in 2016 growth in Ghana decelerated to its lowest rate in the last two decades. By contrast, Côte d'Ivoire and Senegal performed better over the period, registering robust growth rates of 8 and 6.3 per cent respectively. In Senegal, higher public and private investment, particularly in energy, infrastructure, agriculture, fisheries, tourism, textiles, information technology and mining, continued to underpin the economy's growth. In Côte d'Ivoire, growth was underpinned by improvements in the investment environment and increased infrastructure spending in the transport and energy sectors. Growth in West Africa is projected to increase to about 3 per cent in 2017 and 4.2 per cent in 2018, boosted mainly by an improving economic performance in the region's large economies (such as Côte d'Ivoire, Ghana and Nigeria). Emphasis will be placed on the diversification of investments into non-oil sectors, an increase in investment flows due to the floating exchange rate regime (in particular in Nigeria), the recovery in oil price and increase in oil production and better growth outlook due to improving macroeconomic conditions and increased public investment.

Figure 4
Growth performance in Africa and components of growth by subregion, 2015-2017

Source: ECA calculations based on UNDESA (2016) and EIU (2016) data.
Note: e = estimates, f = forecasts.

16. Growth in Southern Africa dropped sharply from 2.5 per cent in 2015 to 1.0 per cent in 2016, the lowest rate among the subregions. This largely reflects low global commodity prices, drought and electricity outages, tighter financial conditions and low business and consumer confidence that constrained economic growth in 2016. Besides, investment grew only modestly, deterred by the continuing lack of electricity and weak business confidence. Not least, labour productivity has followed a downward trend since 2011. In particular, Angola and South Africa registered very low growth outcomes, while growth in Zambia and Zimbabwe has stalled. By contrast, better growth performance in Mauritius, Mozambique and Namibia counteracted the decline in the subregion's slow growth performers. Economic recovery in Europe and the recent ease in monetary policy spurred on the pace of growth in Mauritius and Mozambique. In 2017 and 2019, however, growth in Southern Africa is forecast to rise to 1.7 and 2.7 per cent respectively, primarily because of the expected investment increases in strategic non-oil sectors, such as electricity, construction and technology, in large infrastructure projects and in mining.

17. North Africa also witnessed a decline in growth, which dropped to 2.6 per cent in 2016 from 3.6 per cent in 2015, mainly because of slower growth in Algeria, Egypt and Morocco. In Algeria, the low oil prices discouraged public investment and private consumption, while in Egypt growth was negatively affected by the dampened performance of the tourism sector and a decline in foreign currency earnings. Growth in Morocco was restrained by the 2015/2016 drought, which adversely affected the agricultural sector, with impacts on private consumption, and also on government spending and inflows of foreign direct investment. This decline notwithstanding, growth in North Africa is forecast to rise to 3.3 per cent in 2017 and 3.5 per cent in 2018, thanks to improved political and economic stability in the subregion and a consequent increase in business confidence (in particular in Egypt

and Tunisia), in inflows of external aid and in large infrastructure projects, despite the continuing political challenges faced by Libya.

C. Structural transformation and labour market performance

18. The structural transformation of Africa over the period 2000-2014 follows a pattern in which increases in GDP per capita were associated with a decline in both the value added and employment shares in the agricultural sector. This process was particularly pronounced in the relationship between employment and GDP per capita, indicating the movement of a significant proportion of labour out of the agricultural sector over the period. This has also been associated with a decline in agricultural productivity growth, from an average of 9.9 per cent over the period 2000-2008 to an average of 4.0 per cent over the period 2009-2014.[1]

19. In the manufacturing sector, manufacturing value added gradually increased as GDP per capita rose in the early 2000s, but then declined at the higher stages of development, indicating the failure of African countries to maintain the sector's growth momentum.[2] This, however, is the only sector where productivity increased, rising from 1.9 per cent in 2013 to 3.3 per cent in 2014, while it declined from 4.4 and 0.96 per cent in 2013 to 2.7 and 0.9 per cent in 2014 in the agriculture and service sectors, respectively. At 3.3 per cent, growth in manufacturing labour productivity is much higher than that of the euro area, which measured 0.9 per cent in 2014 (Conference Board, 2015).

20. Where the services sector is concerned, its value added increased steadily over the early years of the 2000s, as GDP per capita increased, before decreasing steadily in the later stages of development. The share of employment in the sector continued to increase steadily over the period, however. This increase in the share of employment could be supporting the narrative that a greater proportion of labour has been reallocated from the agriculture sector to the services sectors with relatively lower productivity (McMillan and others, 2014). Services productivity has declined from an average of 7.5 per cent over the period 2000-2008 to an average of 3.0 per cent over the period 2009-2014, which is the lowest of the three sectors under consideration.

21. Looking at economic groupings, figure 5 shows that the labour productivity of all the groups is projected to grow at an average of 2.8 per cent in 2016 as the global commodity prices recover and as most of the economies increase their investments in non-oil sectors in an endeavour to diversify their economies. The oil-importing and agricultural commodity exporting countries, however, growing at an average of 2.4 per cent, have been projected to lead the groupings' output per worker growth over the period 2014-2016.

22. Labour productivity is one of the key features underlying the dynamic process behind the structural transformation of African economies. The continent has experienced subdued labour productivity, due primarily to lack of diversification in its countries' economic activities. Output per worker declined from 4.0 per cent in 2014 to 1.2 per cent in 2015 and is projected to grow at 2.3 per cent, which is below the global average growth of 2.7 per cent in 2016.

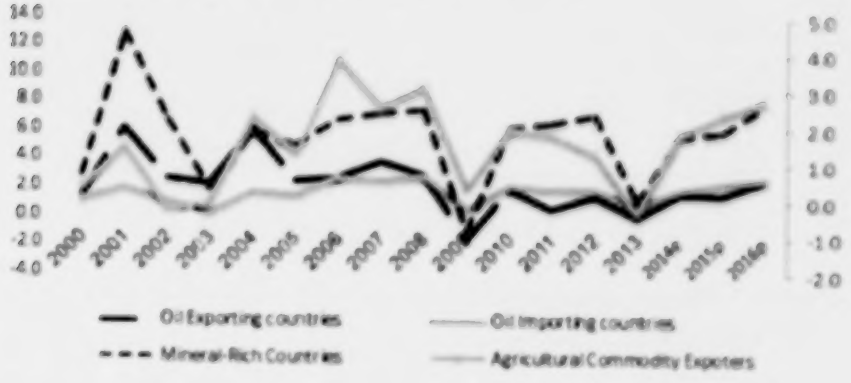
23. Labour force participation and unemployment rates in Africa have settled at around 69.7 and 9.2 per cent respectively since 2014, while male and female unemployment has stabilized around 8.0 and 11.1 per cent respectively since 2014. Women are experiencing higher unemployment rates across all the subregions, but

[1] ECA calculations based on ILO (2016) data.

[2] See 2017 edition of the Economic Report on Africa.

these are more pronounced in North Africa, which displays the worst female unemployment rates of more than 50 percentage points in most countries. Gender gaps in unemployment rates widen further, especially when young people are considered, who registered an average unemployment rate of 16.8 per cent over the period 2014-2016. Despite the economic downturn in West Africa, the growth trend in labour force participation rates is expected to increase. Southern Africa is continuing to enlarge its labour force despite negative effects from lower commodity prices, while stability will prevail in other regions for the coming years. Interestingly, women in some countries in East and Southern Africa have higher labour participation rates than men, for example in Burundi, Malawi, Mozambique and Rwanda.

Figure 5
Productivity growth by country groupings, 2000-2016



Mineral-rich countries and agricultural exporters are on the secondary axis.
Source: ECA calculations based on ILO (2016).
Note: e = estimates, p = projected estimates.

D. Stability of fiscal and current account deficits at the cost of investment cuts

24. The overall fiscal deficit of Africa in 2016 remained the same as in 2015, at 5.9 per cent, as a result of stable fiscal deficits in Algeria and Ethiopia, a narrowing fiscal deficit in Egypt and lower fiscal deficit in Nigeria, countering the widening fiscal deficits in Angola, Kenya and South Africa.

25. Largely driven by low oil prices and increased use of external reserves, the fiscal deficit of oil-exporting countries further widened, from 6.2 per cent in 2015 to 6.5 per cent of GDP in 2016. By contrast, the fiscal deficit of oil-importing countries slightly improved, from 5.6 per cent in 2015 to 5.5 per cent of GDP in 2016. The fiscal deficit of mineral-rich countries was the second highest on the continent, although it declined slightly, from 6.5 per cent in 2015 to 6.1 per cent of GDP in 2016. At the subregional level, North Africa continues to show the largest fiscal deficit in the region, despite the slight decline from 11.7 per cent of GDP in 2015 to 10.7 per cent in 2016.

26. The continent's current account deficit remained stable in 2016, at 7.0 per cent of GDP, with stability also observed in North, Southern and West Africa. At the same time, the current account deficit increased among oil-exporting countries, from 7.7 per cent of GDP in 2015 to 8.2 per cent in 2016. This was offset by current

account balance decreases from 6.3 per cent in 2015 to 6.1 per cent in 2016 among oil importers, and from 8.8 per cent in 2015 to 8.5 per cent in 2016 among mineral-rich countries.

E. Tight monetary policy in most countries

27. Most of the countries, including some of the continent's economic powerhouses, such as Nigeria and Egypt, pursued tight monetary policies to curb the weakening of their currency and the related imported inflation. Central banks raised policy rates to limit the inflationary pressure due to significant currency depreciation (in countries such as Angola, Egypt and others), and the drought-induced rise in food prices (in countries such as Ethiopia and parts of Southern Africa).

28. By contrast, countries such as Algeria, Cameroon, Côte d'Ivoire, Kenya and Morocco maintained loose monetary policy stances over the period. Morocco and Kenya reduced their interest rates to 2.3 and 10 per cent, respectively, taking advantage of subdued inflationary pressures to continue to boost the countries' economic activities and growth, while Algeria reduced its discount rate from 4.0 to 3.5 per cent for the first time in almost a decade, under the pressure of declining liquidity levels due to low oil prices. Most of the countries in West and Central Africa also pursued loose monetary policies, since their common currency (CFA franc) is pegged to the euro. Hence their monetary policies have remained loose, in line with the ultra-loose monetary policy of the European Central Bank.

F. Continued depreciation of domestic currencies amid low commodity prices

29. The persistently low commodity prices over the last couple of years, tightening of monetary policy stances in the United States and large fiscal and current account deficits continued to exert a downward pressure on domestic currencies, leading to further depreciations in most of the big economies in Africa. Countries such as Angola, Egypt, Nigeria and others devalued their currencies in response to high demand for the United States dollar, in the face of declining external reserves due to persistent low oil and commodity prices. As the CFA franc is pegged to the euro, it fluctuates in tandem with movements of the euro against the dollar. The Central Bank of the West African Economic and Monetary Union (WAEMU) held its interest rate steady at 3.5 per cent, as inflation remained below the target rate of 3 per cent. The difference in growth between the United States and the European Union and the rise in United States interest rates will weaken the euro, causing the CFA franc gradually to depreciate.

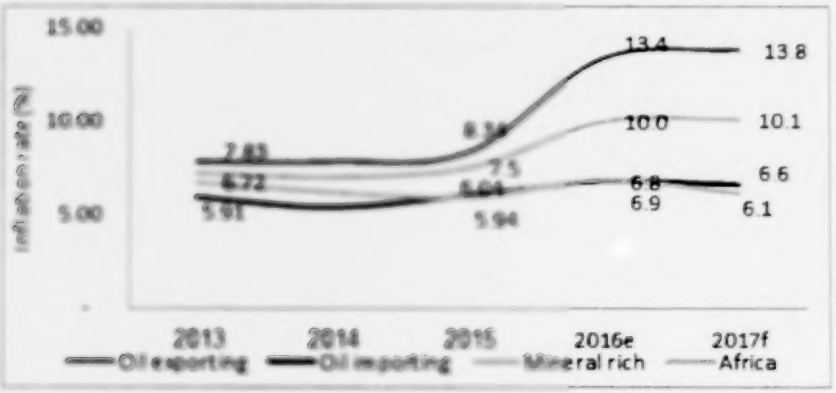
30. The South African rand has been volatile in 2016, with some bouts of appreciation, although by and large it remained subject to depreciations due to domestic policy uncertainty and tight monetary policy in the United States. By contrast, countries such as Ethiopia and Ghana have managed to keep to slight depreciation or maintain currency stability, while the Kenyan shilling has slightly appreciated against its 2015 levels, following the reduced dependence on certain commodity exports, along with healthy external reserves.

G. Increased inflation despite relatively low global commodity prices

31. Overall, inflation on the continent rose to 10 per cent in 2016 from 7.5 per cent in 2015 and is expected to remain at 10.1 per cent in 2017 (figure 6). Domestic supply-side factors (drought impacts on agricultural production), rises in the price

of electricity and currency depreciation together led to the increase in inflation in 2016. Inflation remained relatively high in oil-exporting countries, suggesting the impact of low oil prices due to currency depreciation, along with an increase in regulated prices of electricity that put pressure on inflation in some countries, along with a sharp rise in the prices of food and other forms of energy. Lower oil prices provided some relief, however, and monetary tightening may also have constrained demand-side pressures in most countries.

Figure 6
Inflation by subregion, 2013-2017



Source: ECA calculations based on UNSD SNA (2016) data.
Note: e = estimates, f = forecasts.

II. Continued decline in African trade performance

32. Despite achieving a 17.1 per cent increase in 2011, since then the growth rate of exports from Africa has continuously slowed, declining by 29.6 per cent in 2015 to the lowest rate of all the regions (figure 7). This has come about after the vigorous recovery since 2010 of exports from Africa, which rebounded to their pre-2008 crisis levels mainly thanks, among other factors, to increased agricultural output in most of the countries in East and Southern Africa, increased investment in the mining sector in countries such as Mozambique, the Niger, Sierra Leone and Zambia,[5] and increased demand by China for primary commodities, in particular base metals (IMF, 2015).

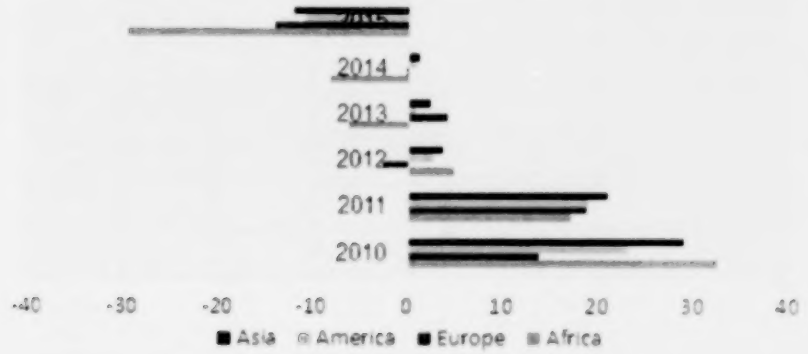
33. Exports by Africa to the world remain poorly diversified and largely dominated by primary commodities, specifically crude oil, gas and petroleum. Indeed, over the period 2010-2015, 55 per cent of African exports to external partners consisted of fuels, with manufactured goods accounting for only 18 per cent. Manufactured goods continue to dominate African imports, however, mainly comprising heavy machinery, automobiles and chemicals. They also continue to constitute the largest share of intra-African trade, averaging some 43 per cent of such trade between 2010 and 2015, although at the global level, their role is marginal, constituting no more than 16 per cent.[6]

34. It is worth noting that, whereas emphasis on the industrialization of Africa is skewed towards the manufacturing sector, the sector's share in total world manufacturing exports remains less than 1 per cent and has been marginally

[5] See Ighobor-Pyle (2015) and UNCTAD (2015).
[6] Authors' computation based on UNCTAD (2016).

declining since 2010. Similarly, the sector's share in the continent's GDP has been slightly but steadily declining since 2010, despite the relative increase in its production. This calls for strategic diversification of the region's export base with increased value addition, to enable it to benefit more from its accrued engagement with emerging markets such as those in Asia.

Figure 7
Exports growth rate by main regions (2010-2015)



Source: ECA calculations based on UNCTAD (2016).

I. Increasing foreign capital inflows

35. Despite the global economic slowdown, the flow of net foreign direct investment to Africa has remained stable, at about 2 per cent of GDP in both 2015 and 2016, partly driven by global economic fragilities and monetary tightening in the United States. The main destinations for such investment in 2016 were Central Africa (Cameroon, the Congo and Gabon), Southern Africa (Mauritius, Mozambique and Namibia) and East Africa (Djibouti, Seychelles and Uganda). Of the subregions, inflows of foreign direct investment were largest in Central Africa (3.7 per cent), followed by Southern Africa (2.8 per cent), East Africa (2.3 per cent), North Africa (1.8 per cent) and West Africa (1.3 per cent).

36. Available data on portfolio investments also show that net portfolio investments deteriorated to $5.3 billion in 2014, compared with $8.2 billion the year before. South Africa, however, as one of the largest recipients of portfolio investments, exhibited a 70 per cent increase in 2015 over both 2013 and 2014 levels. At the same time, a one-third reduction in portfolio investments is reported for Nigeria from its 2014 levels (AfDB, 2016).

37. Official development assistance to Africa has also been stable over recent years, totalling $54 billion in 2014, and rising to $56 and $59 billion in 2015 and 2016, respectively. Total debt increased from 27.8 per cent of GDP in 2015 to 31.1 per cent of GDP in 2016, and is forecast to reach 32.4 per cent in 2017. The fall in international reserves is driven by a decline in net lending in North Africa and oil-exporting countries.

38. Remittances continued their stable flow into African countries, averaging 4.4 per cent of GDP in 2014 and 4.5 per cent over the period 2011-2013. Lesotho

received on average 39.7 per cent of its GDP in remittances over the period 2000-2014. Four other countries (Cabo Verde, the Comoros, the Gambia and Liberia) have received more than 10 per cent of their GDP in remittances over 2000-2014. By contrast, there are 15 countries which have received, on average, less than 1 per cent over the same period. It is worth noting that there are five countries with no data for this period (Central African Republic, Chad, Equatorial Guinea, Mauritania and Somalia), but which together may have received significant amounts of remittances (AfDB, 2016).

IV. African medium-term growth performance: risks and uncertainties

39. A number of internal and external risks could affect the medium-term prospects for Africa. The recent slowdown of global economic growth, economic deceleration in China, the subdued (although improving) performance of the euro area and low oil prices, the depreciation of major African currencies — which, while possibly beneficial for exports, is likely to put pressure on monetary stability through imported inflation — are a concern for African medium-term trade performance. The global economy's weak recovery affects African performance through trade, investment and remittances. Despite the recent increase, low oil prices will continue to weigh on hydrocarbon-exporting countries, although the net effect may be positive for Africa as a whole. The depreciation of major African currencies, while possibly beneficial for exports, is likely to put pressure on monetary stability through imported inflation.

40. The effects of Brexit may slow the global economy, with spillover effects into Africa mainly through trade and financial channels. Trade ties between Africa and the United Kingdom of Great Britain and Northern Ireland may weaken, since some of the trade deals need to be renegotiated through a lengthy process. This may lead to a decline in official development assistance from the United Kingdom. The tight monetary policy followed by the United States also presents a risk over the medium term, which may divert some inflows back to mature markets.

41. Weather-related shocks remain a regional risk, in particular in parts of East and Southern Africa, and could hurt agriculture, which is still the main employer, leading to poor harvests and heightening the risk of inflation through higher food prices. Drought may also affect hydropower generation capacity, threatening efforts by Africa to green its industrialization process. Security in some African countries remains an issue, in particular in Ethiopia, Kenya, Libya and Tunisia, where security concerns have negatively affected the tourism industry. Boko Haram and Al-Shabaab in West and East Africa respectively, and political unrest in some African countries may disrupt domestic economic activities and reduce foreign investment in some countries.

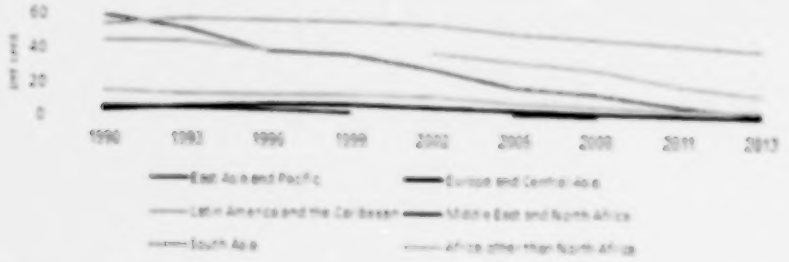
V. Need to link structural change and social development

42. The strong economic growth witnessed in many countries across Africa in recent years has had only a marginal impact on poverty and, in absolute terms, the number of people in extreme poverty stagnated at the 2002 levels.

A. Improvement in some indicators

43. The poverty headcount ratio in Africa increased from 54.3 per cent in 1990 to 55.6 per cent in 2002, but since then it has declined by more than a fourth, falling to 41 per cent in 2013. Overall, poverty in Africa has declined much more slowly than in other regions (figure 8).

Figure 8
Poverty rate at $1.90 a day (2011 PPP), 1990-2013

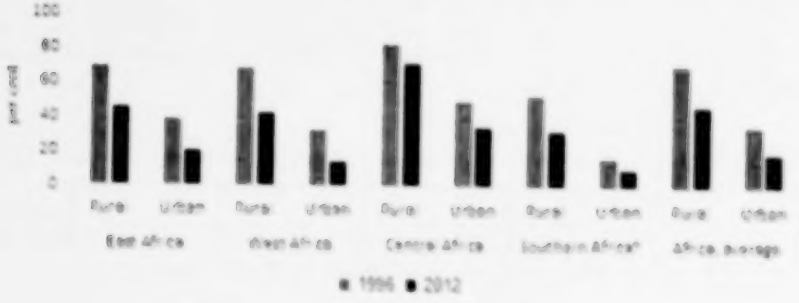


Source: World Bank (2016).

44. Within Africa, poverty declined everywhere and at a faster rate in urban than in rural areas, except in Southern Africa, which has witnessed a marginally faster decline in rural poverty over the period 1996-2012 (figure 9).

45. Over the period 1990-2002, the number of people in extreme poverty increased by 42 per cent, rising from 276 million to 391 million. Since 2002, however, economic growth seems to be having a positive, although slow, impact as the number of people in extreme poverty has remained almost constant, at around 390 million. Still, the percentage of the world's poor that live in Africa has risen from below 15 per cent in 1990, to more than 50 per cent in 2013. Such factors as rapid population growth and delayed demographic transition, the high level of initial rural vs. urban inequality and gender inequality are responsible for the limited impact of economic growth on African performance in reducing poverty.[5]

Figure 9
Rural-urban poverty trends across Africa, 1996-2012



Source: Adapted from Beegle and others (2016).

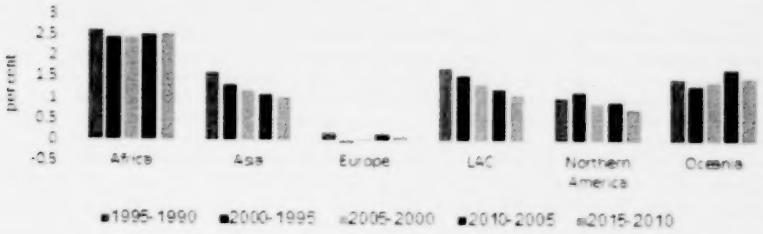
[5] This is also discussed by Chandy (2015).

B. Demographic trends

46. While most of the world has experienced a dramatic decline in both mortality and fertility rates, and therefore in population growth rates, mortality, fertility and population growth rates remain high in Africa. Many demographers have begun to speak of a "stall" in the continent's demographic transition that began in the mid-1990s (Bongaarts, 2008; Goldstone and others, 2014).

47. The population of Africa grew at an average rate of 2.6 per cent per year during the period 1990-2015, more than twice the world average (ECA, 2016). In the same period, Asia and Latin America and the Caribbean regions achieved rapid declines in annual population growth. Not only is the continent's annual population growth rate the highest in the world (figure 10), since 1995, it has even increased marginally, from 2.4 to 2.6 per cent.

Figure 10
Average annual population growth rate, 1990-2015



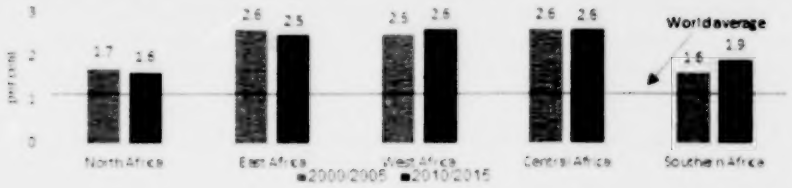
Source: UNDESA (2015).

48. The average annual population growth rate masks vast regional variations, with the average annual population growth high in three subregions (above 2.5 per cent), and increasing in Southern Africa, while declining in North Africa (figure 11). In particular, the populations of Angola, Chad, the Democratic Republic of the Congo, Equatorial Guinea, the Gambia, the Niger and Uganda increased by more than 3 per cent per year. On the other hand, in the small island countries, such as Cabo Verde, Mauritius and Seychelles, along with Lesotho, Morocco and Tunisia, populations grew at around 1.0 per cent per year over the period 2000-2015 (UNDESA, 2015a).

49. Even though the overall population growth rate is slowing, the population of Africa will continue to grow as a result of the existing momentum. Projected changes in population over time can be decomposed into fertility, mortality, migration and momentum effects.[6] In the case of Africa, the fertility component accounts for some three quarters of the projected population increase to 2050 (UNDESA, 2013).

[6] Momentum effects are conditioned by population age structure at the starting point of a projection. In countries undergoing a demographic transition that have a young age profile, population will continue to grow because the birth rate resulting from the large number of women in the reproductive age cohort will exceed the mortality rate.

Figure 11
Average annual population growth across subregions



Source: UNDP (2015).

50. Fertility rates in Africa are falling, but not fast enough, and the gap in fertility rates between Africa and the rest of the world is large and predicted to remain so. The total fertility rate in Africa declined from 6 births per woman in 1990 to 4.4 births per woman in 2014 (World Bank, 2016), although with variations across the subregions. Of the 21 high-fertility countries in the world, with total fertility rates of more than five children per woman, 19 are in Africa. These countries account for around two thirds of the region's population. Projections suggest that, in 2025-2030, the region will account for 14 of the 15 countries with the highest fertility rates in the world (ODI, 2016).

51. Early childbearing is a key contributor to both fertility and high population growth in the region. It also greatly reduces the likelihood of girls continuing their education and limits their opportunities for training and employment. Although fertility in this age range has fallen in most countries, Africa has the world's highest level of adolescent fertility (births per 1,000 women aged 15-19), measuring 98 per 1,000 women over the period 2010-2015, followed by Latin America and the Caribbean at 67 per 1,000 women (UNDESA, 2015b). This, the world's highest adolescent fertility rate, is coupled with its lowest female secondary gross enrolment ratio. Keeping girls in school delays marriage and childbearing. Teenage women are less likely to become mothers when they attend secondary school. The causality also works the other way, and teenage women are less likely to attend secondary school when they become mothers.

C. Relatively high gender disparities exist among African countries

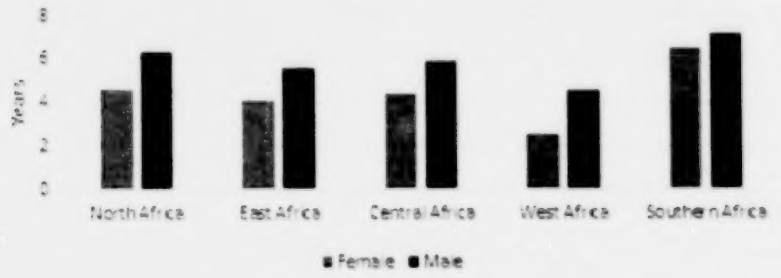
52. Reducing disparities across gender and enhancing women's access to economic opportunities can generate broad productivity gains and improve other development outcomes, including prospects for the next generation. Gender inequality in the labour market results in lost benefits to individuals, households and society. This has significant economic implications, as annual economic losses due to gender gaps in the labour force have been estimated at $60 billion for the African region (Bandara, 2015). Despite significant progress on the continent since 2000 on many fronts, gains have been uneven across countries and subregions, and gender inequality remains a key development challenge in Africa.

53. The gender gap is manifested in access to education. On average, women in Africa receive 4.3 years of schooling, as compared to men, who receive 5.7 years. West Africa is the worst off in this regard, with girls on average having 2.5 years of schooling, or two years less than that received by boys (figure 12). The average gender gap in mean years of schooling is 1.4 years, although in Algeria, the Democratic Republic of the Congo, Equatorial Guinea, Liberia and Togo, the gender disparity in mean years of schooling ranges between 3 and 3.3 years. In the Niger,

girls on average receive less than one year of schooling. This tallies with the fact that, in the Democratic Republic of the Congo, the Niger and Mali, more than half of girls between the ages of 15 and 19 are married (AfDB, 2015), thereby seriously limiting their career prospects.

54. Gender gaps in education have been narrowing but literacy rates for women continue to lag behind those of men. Africa (other than North Africa) records the lowest youth literacy rates, and boys are more likely to be able to read and write than girls. Despite the progress achieved since 2000, the female-to-male literacy ratio for Africa is only 80:100, far below the world average of more than 90:100 (AfDB and others, 2016). Of all the continents, Africa has the widest gap in literacy levels between girls (75.3 per cent) and boys (81.5 per cent): in other words, boys are better off by 6.2 per cent. The performance of the region reflects serious disparities in access to quality basic education and literacy opportunities within the countries.

Figure 12
Gender gap in mean years of schooling by subregion, 2014



Source: Compiled using data from UNDP (2015).

D. Africa expected to be predominantly urban by 2050

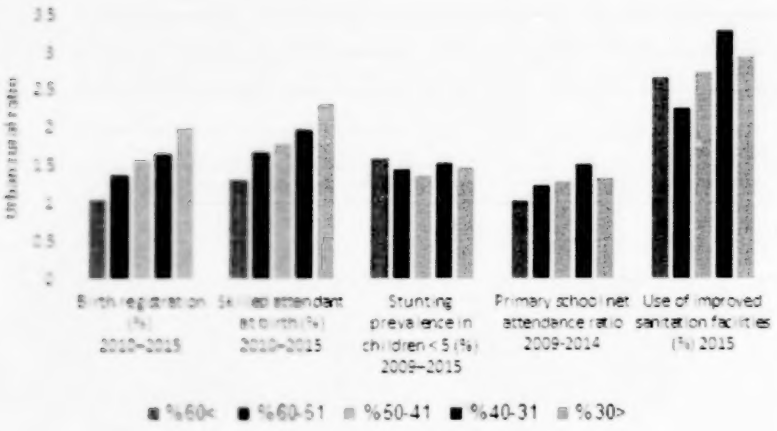
55. Africa is the fastest urbanizing region in the world, although with the lowest proportion of urban population. Close to 60 per cent of people in Africa still live in rural areas. It is estimated that, by 2025, more than half of the population of Africa will live and work in urban areas, compared to the levels of 14.5 per cent in 1950, 28 per cent in 1980 and 34 per cent in 1990. By 2050, Africa will be a predominantly urban continent (UN-Habitat, 2014).

56. The average annual rate of urban growth over the period 2010-2015 was estimated at 3.6 per cent, much higher than in other regions — in China the rate was 2.6 per cent, in Latin America 1.6 per cent, and in Europe 0.4 per cent. Not all countries are urbanizing at the same rate, however: the rate is fastest in those which are least urbanized.

57. Urbanization fosters economies of scale and agglomeration, which in turn are found to spiral economic growth (World Bank, 2009). In almost every country in the world, average living standards in urban areas are superior to those in rural areas. This remains the norm regardless of national income levels, and is usually maintained throughout the development process, as countries transform from predominantly rural and agrarian economies to more urbanized economies with larger industrial and service sectors. In Africa, the size of the urban-rural welfare gap varies a great deal across countries, with larger gaps in countries that are less

urbanized. For most countries, mean consumption in urban areas is two to three times larger than that in rural areas. It ranges from 1.2 in Madagascar and the United Republic of Tanzania to over 2.8 in Uganda and 3.5 in Burkina Faso. Overall, there is a strong positive cross-sectional correlation between the urban-rural consumption ratio and GDP per capita (Fritz and others, 2008).

Figure 13
Urban-rural differentials on various indicators by extent of urbanization, 2010-2015



Source: Compiled using data from UNICEF (2016).

58. The urban-rural discrepancy usually diminishes with urbanization. But there is little urban-rural convergence in access to improved drinking water sources, even in highly urbanized countries (figure 13). In the least urbanized countries, with urban population shares of less than 30 per cent, access to improved drinking water in towns and cities is around 9-29 percentage points higher than in rural areas. Highly urbanized countries in Africa, however, such as the Congo and Gabon, exhibit a 50-60 percentage point difference, which runs counter to the global trend, whereby in countries with high levels of urbanization there is virtually no difference between urban and rural areas in terms of access to basic services.

VI. Conclusion and policy implications

59. The robust growth experienced by Africa over the years since 2000 has weakened markedly, falling to 1.7 per cent, the lowest rate since the beginning of the twenty-first century. The subdued performance in the global economy and slow growth in China, coupled with headwinds on the domestic front, have sown instability in the economic performance of African countries. Slow global growth means reduced demand for goods and services from Africa and reduced capital inflows and investments, suggesting the need for policies and strategies that would support growth through increased consumption, investment and trade.

60. Recent developments in the global economy demonstrate that the dependence of Africa on commodity exports is not sustainable for the continent's growth. The volatility in commodity prices must be addressed by countercyclical fiscal policies and strategies that would support and enhance the structural transformation of African economies. It also calls for improvement of the enabling environment (both

regulatory and operational) for businesses and for programmes to attract foreign investment. The decline in both global demand and commodity prices suggests the need for diversification in African economies and efforts to foster the commodities engagement into value addition through commodity-based industrialization, leading to the structural transformation of these economies. Diversification is widely believed to improve macroeconomic stability, reduce volatility, ensure a more reliable growth trajectory by unlocking production in new sectors, and assist the reallocation of resources to more productive activities.

61. There is need to build the continent's infrastructure, to ensure reliable power supply and efficient transport networks, and to increase investment in research and development, thereby significantly boosting productivity in terms of production efficiency, long-term growth and competitiveness in many African countries.

62. The weakening of domestic currencies, rising interest rate spreads on sovereign debt, and higher volatility in capital inflows from developed and emerging markets, coupled with the instability in the current global economic environment, impede the continent's ability to tap into finance in the international capital market. Accordingly, the need to finance African infrastructure deficits (as one of the priorities of the structural transformation agenda for Africa) compels African countries to explore innovative ways of financing.

63. Women have benefited from growth in Africa, albeit slowly. The big push for universal education over the last 20 years has helped get all children to school and gender parity has almost been achieved at the primary education level. Numerous gains notwithstanding, gender inequality remains a key development challenge in Africa. Policymakers should combine long-term development programmes, such as the provision of social infrastructure and improving the status of women, with short term interventions such as meeting the unmet need for family planning and awareness creation. Moreover, urbanization is increasing in Africa and, unlike global trends, urban-rural differentials in welfare and living standards do not appear to be on the decline. Investing in the development of rural-urban economic linkages, including value chains processing agricultural products and other natural resources, will help to ensure that urban development goes hand-in-hand with rural development.

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Summary of the *Economic and Social Survey of Asia and the Pacific 2017*

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith a summary of the *Economic and Social Survey of Asia and the Pacific 2017*.

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Summary of the *Economic and Social Survey of Asia and the Pacific 2017*

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Summary

While the recent economic expansion of Asia-Pacific countries has been steady, it is modest compared to its recent historical trend amid prolonged weak external demand, rising trade protectionism and heightened global uncertainty. At the same time, decades of rapid economic growth, facilitated by globalization and technology, came at the expense of rising inequalities and environmental degradation. Addressing such economic, social and environmental challenges in a coherent and decisive manner will be critical for the region's future.

In view of such challenges and the 2030 Agenda for Sustainable Development, the *Economic and Social Survey of Asia and the Pacific 2017* was written with an emphasis on the importance of better governance and effective fiscal management. In particular, the quality of governance affects development outcomes through its impact on the composition and efficiency of public expenditure. At the same time, weak governance partially explains the low levels of tax revenues in several countries of the region. Governance impacts the way public revenues are raised by affecting tax morale as the willingness to pay taxes is affected by perceptions of how well tax revenues are used.

In the 2017 *Survey*, it is argued that transparency and accountability in public administration can be improved and strengthened by ensuring production of and access to key data and information, and developing public administration capacities to monitor, evaluate and audit policies and actions. Inclusive institutions, where public service beneficiaries can exchange views with the Government, could also be instrumental for raising tax revenues and making expenditures more efficient. Also highlighted are the roles of e-government, information and communications technology and decentralization in improving governance in the context of fiscal management.

The potential benefits of better governance, as highlighted in the 2017 *Survey*, are large and wide-ranging, including better health outcomes in the Pacific, economic diversification in North and Central Asia, decent jobs in South and South-West Asia, ecological innovations in East and North-East Asia and narrowing development gaps in South-East Asia.

The Commission is invited to consider the issues analysed in the present document and provide policy guidance and recommendations to strengthen governance and fiscal management in order to improve long-term economic prospects and address social and environmental concerns.

I. Introduction

1. Economic growth in Asia-Pacific economies, though steady, is modest compared to its recent historical trend amid prolonged weak external demand and rising trade protectionism. While robust economic growth is not a sufficient condition for achieving broader development goals, the lack of it could undermine poverty reduction and expansion of decent jobs. At the same time, decades of rapid economic growth, facilitated by globalization and technology, came at the expense of rising inequalities and environmental degradation. Addressing such economic, social and environmental challenges in a coherent and decisive manner will be critical for the region's future.

2. Against a backdrop of heightened global uncertainty and narrowing room for monetary policy manoeuvre, a case is made in the *Economic and Social Survey of Asia and the Pacific 2017* for a proactive role of fiscal policy to deal with these challenges through productive investments in such areas as infrastructure, social protection and resources efficiency. It is further argued that this is contingent on better and effective governance, which affects public expenditure efficiency and tax morale.

3. Better governance and effective fiscal management in the Asia-Pacific region can not only improve long-term economic prospects, but also facilitate in grappling with social and environmental concerns. Indeed, balanced progress on all three fronts is the essence of the 2030 Agenda for Sustainable Development. Governance quality, an abstract concept, has been defined to varying degrees by different organizations and institutions. In the 2017 *Survey*, political dimensions, such as democratic accountability, are avoided and governance is framed in terms of how power is exercised instead of how it is acquired. This approach respects the diversity of cultures, historical experiences and levels of development that countries in the Asia-Pacific region share.

4. A more functional definition of governance allows a focus in the 2017 *Survey* on the transmission mechanism through which governance affects various aspects of sustainable development. Specifically, the 2017 *Survey* contains an analysis of the role of governance in the mobilization and allocation of fiscal resources in order to foster development. For this purpose, governance is measured by analysing data on government effectiveness, regulatory quality, rule of law and control of corruption, four of the six worldwide governance indicators. While governance is included in the Sustainable Development Goal framework under Goal 16 by calling upon countries to build effective, accountable and inclusive institutions at all levels, it is argued in the 2017 *Survey* that achievement of this objective can also contribute to the realization of other development goals through better fiscal management.

5. The economic structure and development challenges that various Asia-Pacific subregions and economies are facing differ markedly. To reflect such diversity, a disaggregated macroeconomic analysis for each of the five subregions is provided in the 2017 *Survey*. Also presented are five selected subregional development issues which could be seen as case studies on the way in which effective fiscal policy management and good economic governance can contribute to better development outcomes. These topics build upon the argument made in the 2017 *Survey* that fiscal policy should play a more active role in addressing social and environmental concerns and that effective governance is needed to strengthen the quality of fiscal policy management and deliver impactful domestic structural reforms.

6. The five selected issues are: learning from policy experiences to promote clean energy in East and North-East Asia; diversifying sources of economic growth in North and Central Asia; using fiscal policy to improve health outcomes in the

Pacific; reducing economic informality and creating productive jobs in South and South-West Asia; and addressing binding governance issues to narrow development gaps in South-East Asia.

II. Recent economic performance and outlook

A. Economic growth dynamics

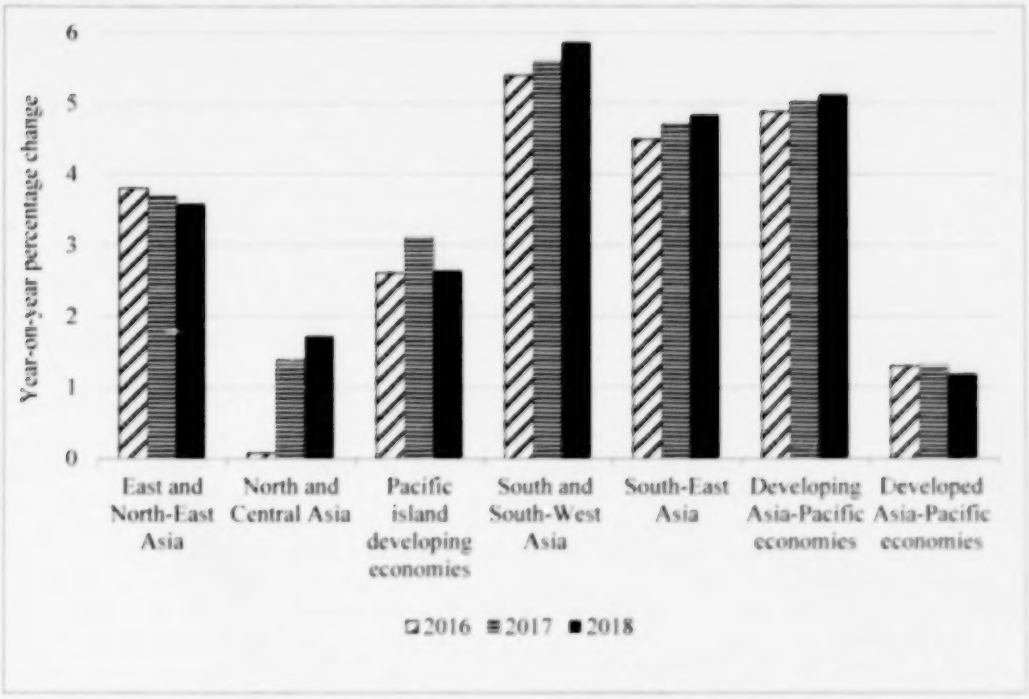
7. Economic growth in the Asia-Pacific region has relied more on domestic demand in recent years, but the boost from low inflation and accommodative policy stances has been smaller than expected. Possible reasons include relatively weak growth in real wages and farm incomes on the consumption side, and uncertainty and excess capacity on the investment side. In some countries, private sector debt overhang was also a major factor. In particular, private investment has not been forthcoming in many countries, which has undermined expansion of decent jobs. Leading indicators such as manufacturing Purchasing Managers Index and the latest export and import data do point to a mild economic recovery in 2017 and 2018. However, this is unlikely to be a firm rebound given that the factors that held back domestic demand remain largely unresolved even as rising trade protectionism effectively offsets potential recovery in external demand.

8. Average economic growth in developing Asia-Pacific economies is projected to rise to 5 per cent in 2017 and 5.1 per cent in 2018, from an estimated 4.9 per cent in 2016 (see figure I). In 2016, stronger than expected economic performance in China and the Russian Federation was offset by considerable slowdowns in India and Turkey. A modest but steady economic outlook for 2017 and 2018 is underpinned by the region's largest economy, China, where higher-value-added sectors are gradually replacing excess-capacity sectors as the driver of output, employment and export growth. A slightly improved economic growth outlook for the rest of the region is facilitated by a recovery in net commodity exporters and public investment in some of the net commodity importers.

9. In East and North-East Asia, economic growth was stable at 3.8 per cent in 2016, though lower than an average growth of 4.6 per cent experienced during the period 2011-2013. The main reason for this slowdown is moderation in economic growth in China in recent years amid structural reforms towards household consumption and services. Economic conditions, however, are broadly stable in China. The steady subregional growth in 2016 is underpinned by a slight economic rebound in Japan and the Republic of Korea, where domestic demand, particularly infrastructure projects and residential construction, has been the main economic growth driver.

10. The near-term economic prospects are stable, with projected output growth of 3.6 to 3.7 per cent in 2017 and 2018. A gradual downward growth trend in China is likely to continue, mostly reflecting ongoing efforts to curb rapid credit growth. An economic uptick in other large subregional economies should sustain the overall economic expansion. As an export-led subregion, a key downside risk is uncertainty over the strength of global trade. An immediate policy challenge is to tackle rising debt burdens while maintaining steady economic growth momentum.

Figure I
Economic growth in the Asia-Pacific region



Source: Economic and Social Commission for Asia and the Pacific (ESCAP), based on: national sources; *World Economic Situation and Prospects 2017* (United Nations publication, Sales No. E.17.II.C.2); International Monetary Fund, International Financial Statistics databases, available from http://elibrary-data.imf.org (accessed 1 February 2017); Asian Development Bank, *Asian Development Outlook 2016: Asia's Potential Growth* and updates (Manila, 2016); and www.ceicdata.com.

***Note*: Data for 2016 are estimates and data for 2017 and 2018 are forecasts. Developed Asia-Pacific economies comprise Australia, Japan and New Zealand**

11. In North and Central Asia, output in 2016 expanded by only 0.1 per cent, though this was much more positive than the 2.7 per cent contraction in 2015. Despite the recovery, subdued global energy prices continue to put pressure on this commodity-dependent subregion. In the Russian Federation, which accounts for about 80 per cent of the subregion's output, the recession was also driven by international sanctions and domestic structural impediments. Similarly, Azerbaijan and Kazakhstan recorded much weaker economic conditions, as sharp currency depreciations in late 2015 pushed up inflation, raised corporate debt burden, and triggered fiscal consolidation. The subregion is expected to experience moderate economic expansion of around 1.4 to 1.7 per cent in 2017 and 2018. The outlook is highly uncertain and contingent upon a further pickup in global energy prices, steady commodity import demand in China and stable geopolitical conditions in the subregion.

12. The Pacific island developing economies experienced a sharp economic slowdown in 2016, with economic growth dipping to 2.6 per cent in 2016 from 6.2 to 7.1 per cent in the preceding two years. The economy of Papua New Guinea, accounting for 60 per cent of the group's output, slowed notably amid subdued prices of minerals. Despite the overall gloomy picture, output growth increased in about half of the subregional economies. The economic outlook is expected to improve slightly, with projected economic growth at 2.6 to 3.1 per cent in 2017 and

2018, aided by an uptick in global commodity prices, steady economic growth in key trading partners like Australia and New Zealand and continued infrastructure upgrades. A key downside factor is the persistent risk of natural disasters. Room for policy responses to adverse shocks is often limited, as public debt levels are already close to established thresholds for fiscal stability in several economies.

13. In South and South-West Asia, despite a slight deceleration in economic growth to 5.4 per cent in 2016, the subregion was the fastest growing in Asia and the Pacific. In India, which accounts for at least half of the subregion's output, economic growth slowed amid weak manufacturing activity and fixed investment. An unexpected demonetization of currency also adversely affected India's economic performance. Economic growth also declined in Turkey as a result of heightened political uncertainty. In contrast, Bangladesh, the Islamic Republic of Iran and Maldives recorded stronger growth performance. Overall, consumer spending propelled economic activity, supported by multi-year low inflation and favourable employment conditions.

14. Output growth is expected to increase further to 5.6 to 5.9 per cent in 2017 and 2018. Private consumption, as well as public investment in some countries, will be the main growth driver. In India, the disruptive impacts of demonetization are likely to be temporary and economic growth is projected to gradually regain momentum. A key downside risk is higher than expected inflation, which could lead to monetary policy tightening and dampen consumer spending. Despite the positive near-term prospects, the subregion's economic development is constrained by inadequate infrastructure and energy. Closing such gaps requires large fiscal spending, which calls for policy tax reforms to restructure state-owned enterprises, expand the tax base and improve tax administration.

15. In South-East Asia, economic growth of 4.5 per cent in 2016 was on a par with that in 2014 and 2015. Indonesia, Thailand and the Philippines registered higher economic growth in 2016, driven by consumer spending and public infrastructure investment. In contrast, Malaysia and Singapore recorded multi-year low economic expansion amid subdued global trade. As in past years, economic expansion in less developed economies of the subregion – namely Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam – was more rapid than in emerging economies in the subregion amid robust manufactured exports and higher foreign direct investment inflows.

16. The economic growth outlook is projected to improve slightly to 4.7 to 4.8 per cent in 2017 and 2018. Supportive macroeconomic policies and low inflation are likely to back household consumption, although the magnitude of the impact may be held back owing to high household debts in some subregional economies. Private investment is expected to remain sluggish amid large spare production capacity and cautious investor sentiments. Key downside risks are possible delays on public investment projects and sluggish import demand in China.

B. Risks to the region's economic outlook

17. Despite a modest uptick expected in most subregions, the overall risks to the economic growth outlook of the region are tilted to the downside. This reflects a significant increase in policy uncertainty at the global level in recent months. The most significant risk is trade protectionism. There has already been a noticeable surge in the number of restrictive trade measures adopted both globally and regionally, as highlighted in the *Asia-Pacific Trade and Investment Report 2016: Recent Trends and Developments*.

18. Recent shifts in policy in the United States of America over trade, currency, immigration and other areas could have further negative impacts on the region, including for goods exports from China and services exports from India. Possible shifts in policy in the United States, together with Brexit and upcoming elections in some European economies, have also resulted in heightened global uncertainty, which undermines investment in the region. Any forgone trade and investment could in turn hurt employment prospects and drag productivity growth in the years to come. An ESCAP analysis suggests that economic growth in 2017 could be up to 1.2 percentage points slower than the baseline projections if an increase in trade protectionism and global economic uncertainty is steeper than anticipated.

19. This comes at a time of potential tightening of global financial conditions, influenced by gradual increase in United States policy rate on the back of better economic data. In effect, this could bring the region's monetary easing cycle to an end. Capital outflow pressures, which increased in the wake of elections in the United States in November 2016 before subsiding recently, are likely to re-emerge with the announcement of United States fiscal stimulus, and lead to further depreciation of regional currencies. Countries in the region with large current account deficits or high short-term external debt, such as India, Indonesia, Malaysia and Turkey, are particularly vulnerable. On the upside, regional exports may benefit from relatively stronger external demand and currency-induced competitiveness, but any boost is likely to be limited owing to the high number of trade protectionist measures.

20. While global commodity prices have largely stabilized over the last couple of years, it remains a source of upside or downside risk depending on whether a country is a net commodity exporter or importer. For instance, if global oil prices overshoot baseline projections of $52 to $55 per barrel, net importers in the region would face higher inflation but net exporters would see faster economic recovery.

21. Within the region, the role of China as originator and transmitter of shocks has increased in recent years. Real or perceived economic instability in China could lead to bouts of financial volatility in the region, as witnessed in early 2016. Given that several regional economies are competing with China in global value chains, the depreciation of the renminbi puts pressure on other regional currencies to also depreciate. On the upside, if economic performance in China is stronger than expected as in 2016, there could be positive trade spillovers.

22. In the medium term, strengthening domestic and regional demand will be critical against a difficult external environment. The rebalancing and opening up of China augurs well for the region in this regard. Initiatives such as the Belt and Road Initiative of China could provide renewed momentum to regional connectivity and intraregional trade, while capital account liberalization in China could dramatically increase the pool of long-term financing available for investments in the region. The future of regional demand also depends largely on whether South Asia realizes its full potential, towards which regional economic cooperation and integration could critically complement domestic efforts.

III. Economic policy considerations

A. Limited monetary policy space

23. Monetary policy stances in the region recently shifted from accommodative to neutral as upside risks to inflation increased slightly. In the first two months of 2017, policy interest rates were on hold in India, Indonesia and the Philippines while short-term interest rates were increased in China. This trend is in contrast to

the previous two years, when policy rates were lowered consecutively or kept at record low levels in these economies plus others such as Pakistan, the Republic of Korea and Thailand. Average inflation in developing Asia-Pacific economies is projected to rise from 3.6 per cent in 2016 to 3.8 per cent in 2017 and 2018. The uptick is more evident if the average excludes North and Central Asia, where inflation has been subsiding after large currency depreciations prompted high inflation in the previous two years.

24. Low policy rates have had a relatively limited impact on domestic demand and thus inflation, indicating limited monetary policy space. The recent uptick in inflation, though mostly due to non-domestic demand factors such as oil prices and exchange rate depreciations, also calls for caution. Likely currency depreciations could further limit monetary policy space, not least owing to its inflationary impact. Nevertheless, raising policy rates would be difficult as well. For instance, leveraged households and firms could find debt service costs rise and refinancing harder, increasing financial stability risks. Thus, economies are advised to maintain the status quo in terms of policy interest rates. At the same time, they should consider strengthening capital flows management and macroprudential measures to mitigate the adverse effects of exchange rate depreciations and to ensure financial stability.

B. Need for a proactive fiscal policy

25. Fiscal policy could play an active role in boosting domestic demand and supporting development priorities, such as reducing poverty, mitigating inequalities and supporting social protection measures. However, its effectiveness depends critically on better and effective governance. Fiscal policy stances in the region have been broadly countercyclical and expansionary in recent years. China implemented large infrastructure projects and tax breaks, India adjusted its medium-term fiscal consolidation path to accommodate higher current expenditures, and the Republic of Korea and Thailand engaged in various stimulus measures. However, net commodity exporters have taken a more cautious approach given terms of trade losses that have affected public finances.

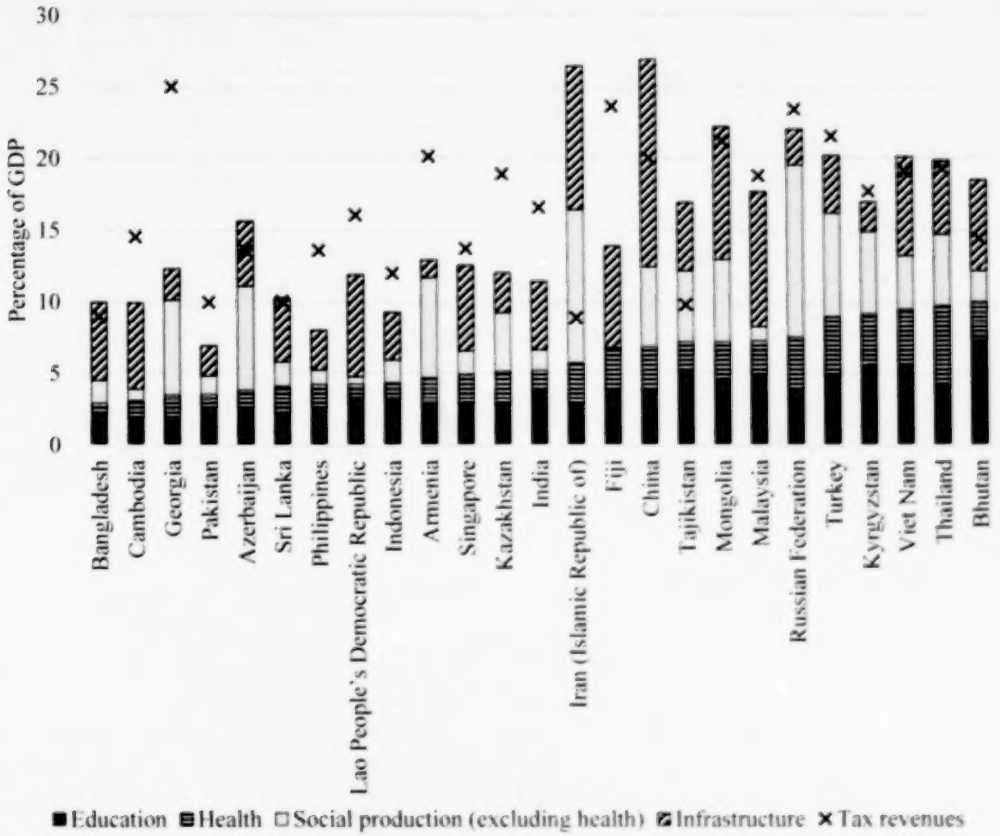
26. Beyond stabilization considerations, there have also been efforts to enhance the composition and quality of public expenditures in support of development priorities. Social spending on education, health and social protection have generally been on the rise, albeit gradually and from a low base, while a number of countries have ambitious infrastructure plans (see figure II). Beyond financing, countries need to pursue broader public sector governance reforms to ensure that spending translates into better development outcomes.

27. Ensuring fiscal sustainability would require tax reforms and effective debt management. Tax collection remains relatively low in the Asia-Pacific region, and the scope for boosting revenues through improved compliance and base-broadening is particularly large. In countries where domestic demand is depressed, some tax relief could be offset by debt finance, taking advantage of the relatively low government bond yields in recent years, although the window of opportunity here may be narrowing.

28. In assessing fiscal sustainability, countries should consider the potential long-term positive spillover effects of social and infrastructure investments on the economy. If the spillovers are sufficiently large, for instance owing to the crowding-in of private investment, ratio of public debt to gross domestic product (GDP) could be stable over the long term. This is an area where more research is needed given mixed empirical evidence. At the same time, expenditure efficiency and revenue enhancement efforts – aspects influenced by better governance – could help contain

the primary balance and make debt dynamics less sensitive to the interest rate-nominal GDP growth differential.

Figure II
General government expenditures and revenue



Source: International Monetary Fund (IMF), Fiscal Monitor Database (available from www.imf.org/external/pubs/ft/fm/2011/02/app/FiscalMonitoring.html; accessed 1 February 2017); IMF, World Economic Outlook Database (available from www.imf.org/external/pubs/ft/weo/2016/02/weodata/index.aspx; accessed 1 February 2017); IMF, Investment and Capital Stock Dataset (available from www.imf.org/external/np/fad/publicinvestment/data/data.xlsx; accessed 1 February 2017); United Nations Educational, Scientific and Cultural Organization Institute for Statistics database (available from http://uis.unesco.org/; accessed 1 February 2017); World Bank, World Development Indicators database (available from http://data.worldbank.org/data-catalog/world-development-indicators; accessed 1 February 2017).

29. The important role of fiscal policy management in promoting social development is evident in Pacific island developing economies. Evidence suggests that current relatively large health spending in the Pacific subregion could be made more effective if more resources were devoted to preventive care and early treatments by specialized health services. Regarding revenue policy, taxes and tariffs have been introduced to discourage consumption of unhealthy products, although there appears to be room for higher tax rates. Policies such as user-pay health-care services and public-private partnerships are also a possible option, but they require careful implementation and effective governance to ensure access to services.

C. Importance of structural reforms

30. Structural reforms could complement monetary and fiscal policies and help lift productivity and potential growth, but sufficient attention must be paid to their distributional impacts. Interest in structural reforms has increased in recent policy discussions, although no definition has been agreed upon. They generally refer to policy, legislative and regulatory changes that increase the efficiency of factor markets (land, labour and capital) and product markets. Recent examples from the region include liberalization of interest rates in China and the new national bankruptcy law in India, which are expected to support private investment. Careful assessment is needed of the distributional and environmental impacts of such growth-enhancing reforms, so that appropriate compensating measures may be introduced. Such reforms could also go beyond the GDP measure as a benchmark to incorporate social and environmental considerations that affect social welfare.

31. In many cases, the driving force for implementing domestic structural reforms is new opportunities brought about by external developments. For example, in North and Central Asia, the Eurasian Economic Union aspires to be a single market with free trade among members, while the Belt and Road Initiative of China aims to improve trade and infrastructure connectivity between China and Europe through the Eurasian land mass. To capitalize on the potential gains from the Eurasian Economic Union and the Belt and Road Initiative, the subregional economies need to reduce domestic regulatory burden, thus enabling firms to benefit from lower cross-border trade costs. As productive capacity increases, more active participation in global supply chains can help widen the subregion's economic base.

IV. Enhancing the quality of economic growth

32. In addition to ensuring sustained and robust economic growth, policymakers will need to address some key social and environmental challenges in order to improve the quality of this growth. In the 2017 *Survey*, after a discussion of recent developments in the region with respect to the labour market, poverty and inequality, there follows an examination of recent trends in social protection and resources efficiency in the Asia-Pacific region as selected topics.

A. Creating decent jobs for poverty reduction and equitable growth

33. Expansion of decent jobs remains a challenge. In 2016, average employment growth in the Asia-Pacific region was modest but remained steady at 1.1 per cent, while the share of vulnerable employment remained persistently high at about 50 per cent. Based on official labour statistics from the past year, few countries seem to have made progress on both quantity and quality (for example, the Philippines), with some succeeding only on quantity (Indonesia) or quality (Thailand, Viet Nam) and others lacking progress on either front (Sri Lanka).

34. In China, the labour market continues to adjust to structural rebalancing in the economy. In India, demonetization has created short-term uncertainty in labour markets, but could help address informality in the longer term. Across the region, some improvement was made in lowering unemployment, although youth still face disadvantages. In 2015 (latest data), real wages growth was relatively robust in South Asia, possibility due to disinflation, and in China, where the share of labour in national income has been recovering.

35. The benefits of economic expansion have accrued relatively less for poor people, as evident from rising income inequality. Sustained poverty reduction in the

context of slower economic growth would need to rely more on enhancing income distribution and addressing non-income factors such as social exclusion. However, income inequality has increased or remains high in many countries, with a significant concentration of wealth at the top. Wide income inequality also undermines social cohesion and hurts long-term economic growth by reinforcing inequality of opportunities.

36. Comprehensive measures are needed to tackle inequality, including labour market policies such as minimum wages and training of low-skilled workers, and fiscal measures such as progressive taxation and social assistance. For example, to tackle rising inequality and high poverty in South and South-West Asia, availability of decent and high-productivity jobs will be a crucial factor, as most households depend entirely on labour income for their living. There is also a need to reduce the prevalence of informal jobs, which typically have low pay and limited social protection. In this regard, more effort is needed to create new high-productivity sectors, as well as to increase value added for existing economic activities, including the agricultural sector.

37. The economic formalization process would benefit from the streamlining of paperwork requirements and linking of incentive schemes, such as financial support, with business registration and basic compliance with labour regulations. Governments could also provide more support to informal workers, including by delinking social security benefits from employees' contributions. All such efforts would require focus on improving various elements of governance.

B. Expanding social protection financing and coverage

38. A robust system of social protection can ensure that no one is left behind, and contribute to strengthening domestic demand in a more equitable and durable manner. Key aspects of a social protection floor include universal access to affordable health care, free primary and secondary education, unemployment benefits for wage earners and income-support measures for those in need, contributory and social pensions, and full access to social benefits for persons with disabilities.

39. Aside from fulfilling people's rights, greater social protection can help strengthen domestic demand by reducing precautionary savings, so that poor people can consume adequately and also invest in higher-return livelihood strategies. Social protection can also improve the functioning of labour markets by facilitating skills development and employment, which is especially important in economies that are undergoing rapid structural changes.

40. The Asia-Pacific region is currently falling behind the rest of the world in terms of social protection financing and coverage, although there are some successful examples in the region. Average total expenditures, including on social insurance, social assistance and labour market programmes, stand at 5.3 per cent of GDP in the region, compared with the world average of 8.6 per cent. Effective coverage of social protection is limited; in the case of unemployment benefits (contributory and no-contributory), for instance, it is limited to 7 per cent of the labour force in the region, compared to the world average of 12 per cent. In particular, expanding coverage to the large informal sector remains a challenge, although countries such as China and Thailand have been able to successfully establish universal health care and pension schemes through a combination of contributory and non-contributory schemes. There have also been innovative approaches to expanding coverage, such as employment injury insurance in Bangladesh and Malaysia and the rural employment guarantee in India.

41. The development of social protection floors is a multi-step process that includes a national social dialogue, financing strategy and delivery mechanisms. As with public goods in general, social protection is a matter of political choice which requires sufficient national dialogue. This is especially the case for developing national floors and universal schemes, which a growing number of countries are considering. Successful country experiences, as well as simulation exercises, show that universal schemes can be affordable.

42. Options to finance social protection schemes include budget reallocation, such as phasing out untargeted subsidies and containing wage bills; expenditure efficiency, such as direct benefit transfer; pension and health system reforms, such as increasing incentives to use community-based health services; and revenue enhancement. Coverage could be expanded progressively, as was done in China for the rural population and then the uninsured part of the urban population. Synergies should be sought, for instance, by strengthening public health infrastructure through public employment programmes. Labour market programmes, although less widely used in the region, could enhance the economic growth impact of social protection.

C. Internalizing the costs of environmental degradation

43. Although not captured in the GDP measure, environmental degradation and carbon emissions reduce social welfare and undermine the sustainability of economies. Air pollution is now the world's fourth leading fatal health risk, causing one in ten deaths in 2013; in a recent study, the associated welfare loss is estimated at about $5 trillion. Even with continued efficiency gains, global carbon emissions are projected to rise by 13 per cent by 2035 in the base case, which is far in excess of the 30 per cent reduction required to achieve the goals set out in the Paris Agreement. Unplanned urban expansion and conversion of agriculture, forests, wetlands and other ecosystems have also increased vulnerability to natural disasters and the impacts of climate change. At the global level, climate change is now a grave threat to humanity.

44. The region's rapid economic growth in the past few decades was achieved, in part, on the back of environmental degradation with concomitant health impacts, and intensive and inefficient use of resources and natural wealth. The region is highly vulnerable to climate change, the adverse effects of which can substantially undermine the economic development gains in the region and could force more than 100 million people from the region into extreme poverty by 2030. Clean air, safe drinking water, sufficient food and secure shelter – key determinants of health – are also being adversely affected.

45. Despite gradual improvements, the region falls behind the rest of the world on energy and carbon intensity levels. On average, developing Asia-Pacific economies use twice as many resources per dollar of GDP as the rest of the world. Despite steady reductions since the 1990s, the region's energy and carbon intensity levels of production remain relatively high. With the region's growing weight in the global economy, this has meant that the region's share of global energy consumption and greenhouse gas emissions has also increased despite improvements per dollar of GDP. Albeit from a low base, per capita consumption and emission levels have steadily increased and are now on a par with the rest of the world.

46. A mix of regulatory, market-based, and voluntary and information-based policy instruments can be used to address environmental imbalances. Compared to regulations, economic instruments that rely on prices or markets to function are less information-intensive and have superior allocative efficiency, but they can exert less control over the actual environmental outcome. They include taxes, subsidies and

emissions trading systems. Voluntary and information-based measures, such as eco-labels and corporate sustainability reporting, have relatively low implementation costs but could have limited sectoral coverage.

47. A clear example of policy effort to achieve more environmentally friendly economic growth is in East and North-East Asia. After years of heavy industrialization which led to deteriorating environmental conditions, the subregion is now focusing on green growth and developing energy-efficient and renewable technologies. Together, China and Japan account for nearly half of the world's commercial investments in clean technology, while China accounts for most of the world's patent filings in climate change mitigation technologies.

48. Experiences from the subregion point to three desirable aspects of public policies to promote clean energy, all of which highlight the important role of effective governance. The first dimension is a well-designed governance structure that features a whole-of-government approach, effective monitoring and evaluation mechanisms, and multi-stakeholder partnerships from development to diffusion of technology. The second aspect is a balanced policy framework in which Governments consider a mix of incentives, such as favourable pricing of renewable energy, and regulations, such as the setting of minimum energy-efficiency standards. The third dimension is an enabling financing system, particularly non-traditional, green financing instruments such as carbon trading and green bonds.

V. Governance, fiscal management and development outcomes

A. Governance and development outcomes

49. According to the worldwide governance indicators, a marginal improvement in institutional quality has been observed, on average, in the Asia-Pacific region over the past two decades. This trend primarily reflects improvements in East and North-East Asia and in landlocked developing countries, particularly in North and Central Asia. These improvements can be explained by the general increase in income levels, and the demand for better institutions that results from a rise in the middle class and a better-educated population. Furthermore, amendments to laws and regulations as well as their implementation have played a critical role in changing the perceived quality of governance.

50. As shown in the 2017 *Survey*, better governance and effective institutions affect all three aspects of sustainable development. For instance, in terms of economic outcomes, governance affects the capacities of an economy to have access to a skilled labour force, improve investment prospects and sustain innovation. All these factors in turn help enhance the level and pace of productivity, thus improving the long-term economic prospects of an economy.

51. When institutions are weak, inequalities tend to increase and the pace of poverty reduction declines. The main issues discussed in the 2017 *Survey* are misallocation of resources and market inefficiencies; a less progressive tax system that favours well-connected people and high-income households; and greater difficulties for low-income households to borrow because of weak enforcement of rules. Weak institutions also partially explain inequality in access to social services, particularly for women as well as for the poorest and most vulnerable segments of the society.

52. The quality of governance is also important for environmental outcomes, as reflected, for instance, in varying capacities to make and apply environmental rules and safeguards. At the same time, good governance can foster ecological innovation

and technological transfer which positively contribute to the reduction of environmental degradation, as seen in the earlier example of East and North-East Asia.

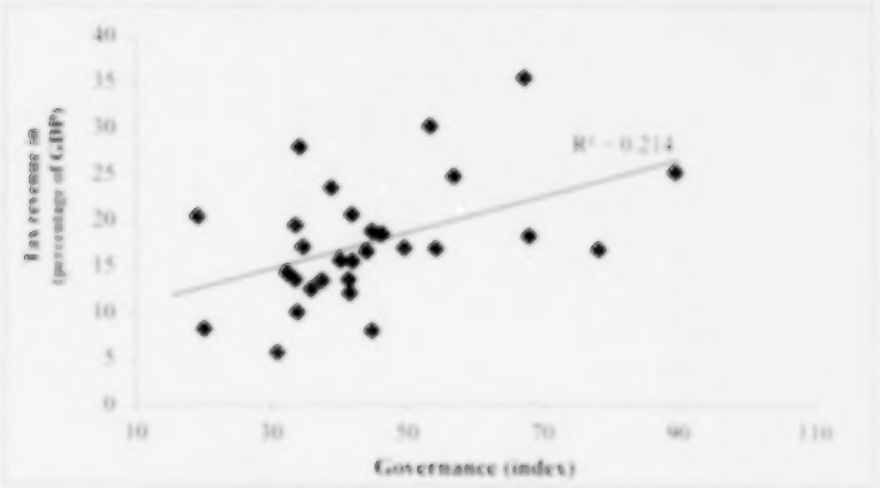
53. Effective governance can also help close development gaps across countries by contributing to the success of reforms that allow poorer countries to benefit more from regional economic integration. In South-East Asia, the average income per capita in emerging economies is over 10 times that of Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam. Development gaps in terms of education and health outcomes are also notable. Narrowing such gaps is important because it would better help Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam to fully realize the potential gains of the Association of Southeast Asian Nations Economic Community. Among other areas, structural reforms aimed at enhancing public infrastructure, labour skills and social protection in Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam are key to closing the development gap.

54. The necessary conditions for the successful implementation of these reforms are effective economic governance and strong institutional quality. Various governance issues could be strengthened in Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam, such as the need to strengthen law enforcement, ensure property rights and increase judicial independence. Similarly, promoting greater use of the criminal justice system in addressing corruption, enhancing cross-ministerial coordination to avoid duplication of work and introducing more transparent business regulatory framework can go a long way to improving development outcomes in Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam.

B. Better governance to improve tax revenues and enhance public expenditure management

55. Weak governance partially explains the low level of tax revenues in several countries in the region (see figure III). This impact can be a result of high levels of corruption, which tends to reduce tax collection in relation to GDP and foster higher levels of tax evasion. Other factors that contribute to or encourage fiscal corruption include complicated tax laws; excessive discretionary power vested in tax administrators and the necessity for frequent interactions between taxpayers and tax officials; weak legal and judicial systems; lack of accountability and transparency in tax administration; and low salaries in the public sector.

Figure III
Governance and tax revenues in Asia-Pacific countries



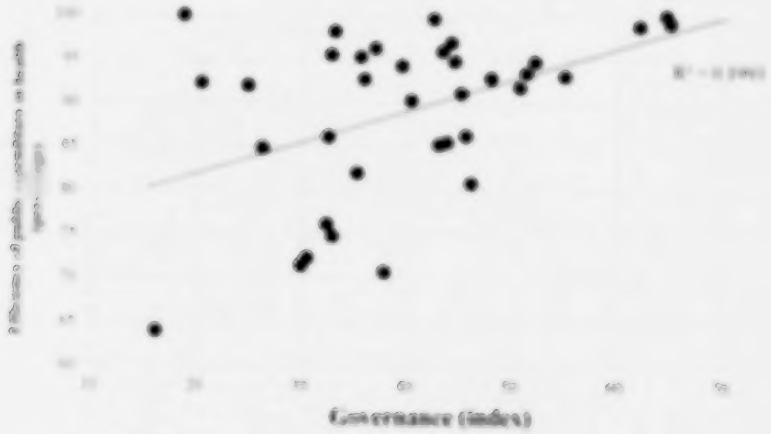
Source: ESCAP, based on data from World Bank, World Development Indicators database (accessed 15 November 2016) and World Bank, Worldwide Governance Indicators (available from http://info.worldbank.org/governance/wgi/index.aspx#home, accessed 15 November 2016).

96. Governance also impacts the way public revenues are raised by affecting tax morale, as the willingness to pay taxes is affected by perceptions of how well tax revenues are used. Thus, while taxpayers will generally be willing to pay taxes if they perceive that the level of public services that is offered is commensurate to their tax bills, taxpayers will shirk their tax responsibilities if they see a mismatch between tax liabilities and services. Low tax morale may also be linked to the perception that evasion of taxes is widespread, especially among those with higher incomes. The 2017 Survey contains an estimate that a decline in governance indicator scores explains up to 8 per cent and 21 per cent of the decline in tax revenues in Pakistan and Bhutan respectively from 2005 to 2014.

97. The quality of governance also affects the achievement of development goals through its impact on the composition and efficiency of public expenditure. For instance, corruption has been shown to distort the structure of public spending by reducing the portion of social expenditure that goes on education, health and social protection. In contrast, better governance has been found to increase the impact of public health spending on child mortality rates (see figure IV), as well as making public spending on primary education more effective and leading to higher attainment in primary education.

Figure IV

Governance and public expenditure efficiency in the health sector in Asia-Pacific countries



Source: E/ESCAP/73/INF/2, based on data envelopment analysis of variables retrieved from the World Development Indicators database (accessed 15 November 2016).

Note: Efficiency scores are based on the comparison between actual input (public expenditures) and theoretical input that should be used to obtain the same level of output (health outcomes).

58. Moreover, less social expenditure also usually goes hand in hand with greater expenditure on items such as law and order, fuel and energy subsidies, and defence. The 2017 Survey contains an estimate that between 2005 and 2014, the impact of better governance and effective implementation of policies on public sector efficiency ranged between 0.34 per cent in the Russian Federation and 57 per cent in Georgia in the health sector, and between 0.15 per cent in Timor-Leste and 32 per cent in Indonesia in the education sector.

C. Policies to improve governance for better fiscal management

59. Improving transparency and accountability in public administration is the key to better fiscal management. As argued in the 2017 Survey, transparency and accountability can be improved and strengthened by ensuring the production of and access to key data and information, developing governmental mechanisms related to monitoring, evaluating and auditing policies and actions, and creating inclusive institutions where public service beneficiaries can exchange views with the Government. Using e-government tools, promoting decentralization and reforming tax and expenditure policies can also contribute to the implementation of these activities as a means of improving transparency and accountability.

60. A regional assessment suggests that several Asia-Pacific countries require public officials at different levels to declare their financial assets to help increase the integrity of civil servants as well as public trust in them. This has improved the efficiency of government expenditures and the overall quality of governance, though further improvements are needed in public access to and coverage of pertinent information, as well as in monitoring and oversight of implementation of such policies.

61. Ensuring access to meaningful fiscal information contributes to greater transparency. However, information on the availability of resources received by the

various government units responsible for the delivery of public services and public access to key fiscal information remain difficult in several countries in the region, even though these policies have yielded positive results in the cases of Georgia, the Republic of Korea, Samoa and Singapore. Furthermore, when information is published, the quality and utility of the published government financial data seems to be low, particularly in North and Central Asia. Besides producing and disseminating information, government officials will also need to better manage operational risks associated with the execution of the budget, whether related to tax revenues or expenditure, through internal controls and audits and external audits.

62. An assessment of public financial management in selected Asia-Pacific countries shows that there is considerable room to strengthen internal controls and external and internal audit functions. For instance, Public Expenditure and Financial Accountability assessments show that, in several countries, there are issues related to the comprehensiveness, relevance and understanding of internal control rules and procedures. Similarly, the degree of compliance with rules for processing and recording transactions is weak. Concerning internal audit, Asia-Pacific countries face concerns related to the frequency and distribution of reports, and the extent to which management follows recommendations from internal audits. Lastly, concerning external audits, the major concerns are the scope of external audit, adherence to international standards and the timeliness of submission of reports.

63. In addition to audit and control functions within the public administration, the integration of the views and concerns of citizens is important as it allows the effectiveness of a policy to be checked and tax morale and revenues to be raised. Enhancing transparency and strengthening accountability requires effective feedback systems to be established, through which users are informed of the existence of such tools and are able to report wrongdoing by officials or assess the quality of public services.

64. The implementation of the above-mentioned policies can be optimized through information and communications technology and through a wider use of financial products by beneficiaries of public services and taxpayers. Tax revenues can substantially increase through deployment of an e-system for tax return and tax filing. Public expenditure efficiency can also increase through e-systems because government programmes can be better coordinated, such as in Malaysia with the eKasih system, or funds can be tracked up to the final beneficiary, such as in India with the payment of social benefits or wages through bank accounts. While e-government systems present opportunities for public financial management and progress has been made during the last decade, Asia-Pacific countries could take greater advantage of those opportunities. Overall, countries with special needs (least developed countries and landlocked developing countries), which face governance issues, do not tend to use e-government platforms even though they could benefit greatly from their usage.

65. Efforts are needed to improve information flows across relevant government departments. For instance, the tax-enforcement function depends on a central database and flow of information from different sources, particularly in the case of value added tax and income taxes. However, a typical approach in the organization of tax administrations in developing countries has been to establish separate revenue departments overseeing different tax bases. This results in little information-sharing among the departments and difficulties in reconciling data and information on taxpayers. Some countries, such as Maldives and the Philippines, have addressed this problem by reorganizing the tax administration along functional lines.

66. Through greater ownership of local revenues, fiscal decentralization can strengthen accountability and improve the efficiency of public expenditure.

However, at the subnational level, gap-filling transfers and shared revenues are preferred to own-source revenues in several Asia-Pacific economies. Measures such as control over rate structures at the local level could be more effective in generating accountability, even if all or some elements of tax administration are managed at a different level. Given more limited capacities, subnational administrations could also consider adopting piggyback taxation, whereby tax revenues are collected using the tax base identified by the central Government and a surcharge is added to the tax rate. Accountability could also be improved by using a property tax system that accounts for the size and location of the property and the cost of public services delivered.

VI. Concluding remarks

67. How societies invest, innovate and ensure that no one is left behind is largely dependent on the quality of governance, or on how much trust and confidence people have in their institutions. As countries in Asia and the Pacific continue to undergo extensive structural transformation, as reflected in the ongoing rebalancing in China and reforms in India, the role of governance will only increase. In the 2017 *Survey*, the issue of governance is examined in the specific context of fiscal management, given the growing demands on fiscal policy to support the economy and address diverse social and environmental challenges.

68. Examples of countries in the region that have successfully scaled up infrastructure outlays, expanded social protection coverage and enhanced the efficiency of resources all point to the importance of good governance and effective fiscal management. Medium-term challenges facing different subregions, such as economic diversification in North and Central Asia, also call for better governance. Moreover, although not touched upon in this document, another dimension of governance – that is, trust and confidence among countries in Asia and the Pacific – will be critical for advancing regional economic cooperation and integration and sustaining the region's dynamism against a difficult external environment.